Department of Defense

November 15, 2006

Performance and Accountability Report

Fiscal Year 2006

Report Documentation Page

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November 15, 2006

In early 2001, the Department of Defense embarked on a comprehensive effort to prepare for the threats and challenges of a new era. At the heart of this effort was the transformation of not just a military still postured to fight the wars of the past, but also the myriad business systems and processes that hampered the Department's ability to support fully and efficiently the warfighters who defend the Nation. Addressing these dual challenges has been a major task of the Department of Defense for the past six years.

While transformation began well before the attacks on America of September 11, 2001, the resulting global war on terror gave urgency to the effort already underway. Some of the ways the U.S. military has been changing to meet the challenges ahead include:

- Modernizing the Nation's warfighting capabilities, to include those needed to fight and win a new kind of war.
- Standing up new organizations to protect and defend the homeland from advanced as well as conventional attack.
- Implementing a new defense strategy, a new force-sizing construct, a new approach to force planning, and a new way of balancing risk.

Recognizing the incongruity of running the military of the future with an organization anchored to the past, the Department simultaneously embarked on a course to bring its business systems and processes into the 21st century. After four years of planning and development, two comprehensive and integrated plans were released in 2005:

- The Financial Improvement and Audit Readiness Plan, which guides the effort to resolve material weaknesses, improve financial practices, and strengthen internal controls.
- The Enterprise Transition Plan, which details the actions, milestones and costs of initiatives across the Department.

These plans show the Department's continued progress in reducing the cost of operations, increasing speed and efficiency, and improving internal controls and financial accountability, thereby supporting the warfighters who defend the Nation.

Both efforts – modernizing the military, and the systems and processes that support it – have the complete and enthusiastic support of the Department's senior military and civilian leaders.

The Fiscal Year 2006 Performance and Accountability Report describes the challenges and presents the financial management and business transformation accomplishments of the Department of Defense during the past fiscal year. The report contains the most complete, reliable financial and performance data available—noting information that is either unavailable or incomplete—and discusses plans for improving the data and the progress to date. The report also includes the Department's annual statement of assurance with respect to internal controls, and our commitment to full compliance with established guidelines and standards. I am pleased to present it to the President, the Congress and the American people.

Gordon England

Overview

The Department of Defense Fiscal Year (FY) 2006 Performance and Accountability Report (PAR) provides the President, Congress, other Federal departments and agencies, and the American public with an overview of the Department's financial condition. Essentially, the PAR is equivalent to the private sector's annual report to their stockholders and includes an assessment of program performance. The report covers the 12-month period ending September 30, 2006 in the following four sections:

Section 1: Management's Discussion and Analysis is a high-level summary of the Department's performance and financial information for FY 2006. It highlights the Department's FY 2006 annual performance goals and results. In addition, Section 1 provides financial highlights for FY 2006 and a statement on the limitations of the financial statements; management assurances over internal controls, summaries of the Department's progress in implementing the Financial Improvement and Audit Readiness Plan, its Enterprise Transition Plan initiative, and the President's Management Agenda objectives. This section concludes with a discussion of potential future effects of current events and conditions facing the Department in 2007 and beyond.

Section 2: Performance Information presents the Department's strategic plan, strategic objectives, strategic goals, performance goals, annual performance results for FY 2006, and a summary of programs assessed using the Office of Management and Budget's Program Assessment Rating Tool.

Section 3: Financial Information includes a message from the Chief Financial Officer, the Department of Defense Inspector General Auditor's Report with its opinion on the FY 2006 financial statements, and the Department's principal financial statements and notes.

Section 4: Other Accompanying Information includes a summary of management assurances over internal controls and corrective actions plans; the Inspector General's Summary of Management and Performance Challenges, the Government Accountability Office's high risk areas related to the Department, and management's response to these auditor assessments; the Improper Payments Information Act reporting details and corrective action plans; and the financial statements for the Executive Office of the President funds managed by the Department.

Appendixes include a glossary and a list of Internet links for documents cited in the report.

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Year in Review

The Department of Defense continues to succeed at its mission while balancing efforts to thwart threats to our Nation and allies. We concurrently seek to transform the organization as we position ourselves for the future.

This year marked the fifth anniversary of a horrific day in our Nation's history. While we continue to face the challenge of terrorist extremists determined to impose their radical ideology on the world, the Department of Defense has made great progress in reducing the threat they pose. Significant sources of terrorist funding are gone. Major sanctuaries, once used to train new recruits or launch attacks, have been reclaimed by their legitimate populations, and extremists not already dead or in jail are finding their days numbered.

Pakistani earthquake victims crowd around a U.S. Army CH-47 Chinook helicopter delivering disaster relief supplies to the earthquake devastated area surrounding the town of Oghi, Pakistan on October 17, 2005.

Such progress was made possible by the heroic efforts of the men and women of America's Armed Forces. From combat operations and training of Afghan and Iraqi security forces, to the mission of providing humanitarian assistance at home and around the world, America has witnessed a truly impressive display of the skill and dedication of young patriots – volunteers every one – who are giving everything of themselves to secure peace and freedom for our citizens and those of other nations.

While extremists in London, Mumbai, Madrid, Morocco, Bali, Beslan, Baghdad, and dozens of other places across the globe continue to murder hundreds of innocent civilians, U.S. forces are making significant strides in removing these extremists from the societies in which they hide. Pockets of remaining Taliban

fighters meet their demise each week in Afghanistan. Abu Sayyef rebels are losing their grip on the Philippines. Abu Musab Zarqawi, the terrorist leader of al Qaeda in Iraq, who incited sectarian violence and killed thousands of innocent men, women, and children, was killed in a bombing raid. Subsequent operations have eliminated dozens of extremist leaders and terrorist safe houses in Iraq.

Iraqi voters line up outside a polling site in Barwana, Iraq during Iraq's first free, permanent parliamentary government elections on December 15, 2005.

The formation this year of the new Iraqi prime minister's cabinet was a significant step forward in strengthening the permanent government of Iraq. It is a government that not only represents all of Iraq's various communities for the first time in that nation's history, but one that is pursuing a national reconciliation with those who have remained outside the political process.

Iraq's security forces continue to gain strength as well. In October 2005, there were some 196,000 trained and equipped Iraqi security forces. A year later, that number is approaching 300,000. Through training and close mentoring, Coalition forces have moved from a lead to a supporting role in many operations, and security responsibilities are increasingly being turned over to Iraqi forces.

In Afghanistan, the nation's security forces are receiving training and support from a growing NATO presence in that country. Although they gain relatively little public notice, reconstruction projects in Iraq continue to reach completion. Increased electricity generation is benefiting more than one million homes in Iraq, and nearly two million more Iraqis now enjoy clean drinking water. More than 200 kilometers of roads, and more than 4,000 schools, have been built in Iraq, with hundreds more in Afghanistan and the Horn of Africa, where Coalition forces have also brought water and electricity to millions in need of essential services.

All of this progress contributes to the overall advancement of civil society in troubled regions. For every new student able to pursue an education, there is a parent who sees the potential benefits that an education holds for their child's future. For each house that receives clean, running water for the first time, there is a tangible incentive to keep that house free of terrorists or weapons that would place that benefit at risk. As life improves, freedom and democracy take root and grow.

Locals wait to be seen by U.S. military medical personnel outside the compound gate in Gode, Ethiopia during a 3 day medical civic action program on November 9, 2005.

Throughout FY 2006, the Department has also provided aid and humanitarian assistance to thousands in need, from the marshes of the Gulf Coast to the jungles of the Pacific Rim. Navy and Marine Corps assets proved invaluable in evacuating thousands of American citizens from Lebanon during a terrorist crisis in that country, and the Army Corps of Engineers completed repairing and improving levees, in and around New Orleans, to heights and strengths to at least what they were prior to Hurricane Katrina.

Despite a war and major disasters, the Department of Defense transformation is moving forward, reflecting the realities of a new age by realigning global posture, developing new technologies to safeguard our forces, and applying innovative business practices to what had been an industrial age bureaucracy.

These remarkable achievements could not have occurred without the professionalism and dedication of America's men and women in uniform, and the dedicated civilians who support them. In a world full of challenge and change, they are a shining beacon of steadfast and noble service. We thank them for all that they do, and for all that they are.

Section 1:
Management's Discussion and Analysis

Heraldry, a system of identification using visual symbols, became a useful art in the Middle Ages, when warriors on the battlefield displayed an emblem on their shields and the tunics they wore over their armor. In America, heraldry symbols have been used by military forces as well as other organizational elements of the government since the beginning of the Revolution.

The Great Seal of the United States is a symbol familiar to Americans. In addition, each department and agency of the government has its own seal which appears on documents and publications issued by the organization. The seal of the Department of Defense, shown above, was designed to visually depict the mission of the Department.

The American bald eagle, long associated with symbolism representing the Untied States of America and its military establishment, is an emblem of strength. In facing to the right, the field of honor is indicated. The eagle is defending the United States, represented by the shield of thirteen pieces. The thirteen pieces are joined together by the blue chief, representing the Congress. The rays and stars above the eagle signify glory, while the three arrows are collectively symbolic of the three component parts of the Department of Defense (Army, Navy, and Air Force). The laurel stands for honors received in combat defending the peace represented by the olive branch.

Mission and Organizational Structure

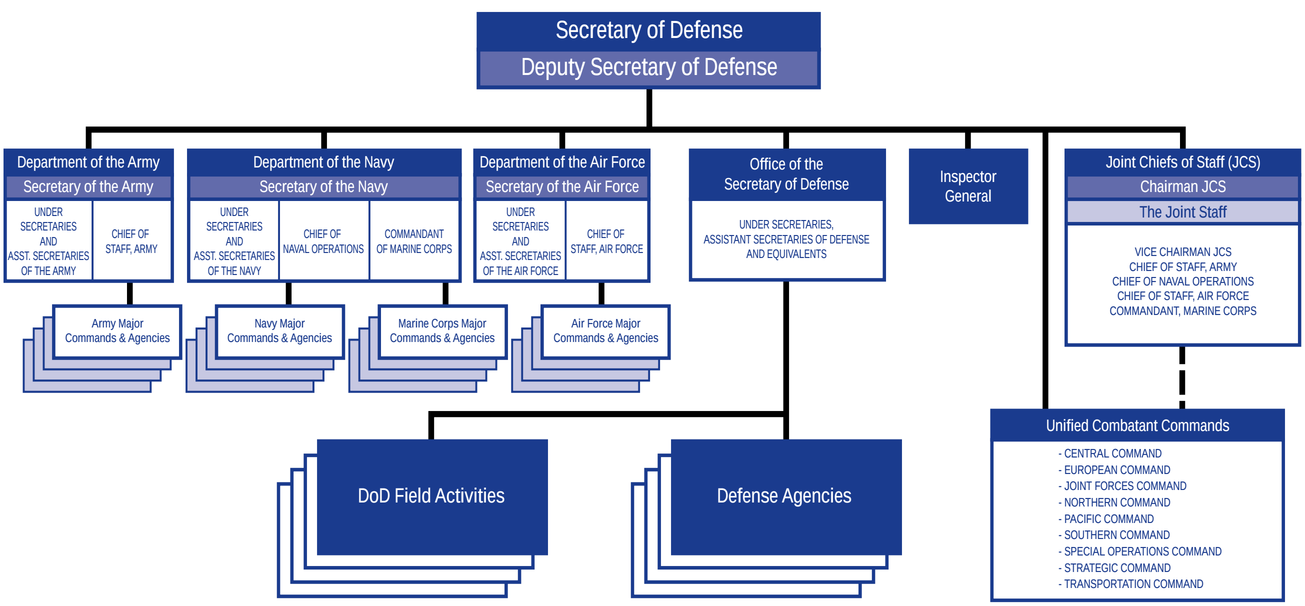
The mission of the Department of Defense is to provide the military forces needed to deter war and to protect the security of our country. The Department is America's largest, busiest, and most successful organization. Since the creation of America's first army in 1775, the Department and its predecessor organizations have evolved into a global presence of 3 million individuals, stationed in more than 140 countries, that are dedicated to defending the United States by deterring and defeating aggression and coercion in critical regions. The Department embraces the core values of leadership, professionalism, and technical knowledge. Its employees are dedicated to duty, integrity, ethics, honor, courage, and loyalty. The chart below shows how the Department is structured.

The Secretary and the Office of the Secretary

The Secretary of Defense and the Office of the Secretary of Defense are responsible for the formulation and oversight of defense strategy and policy. The Office of the Secretary of Defense supports the Secretary in policy development, planning, resource management, and fiscal and program evaluation.

Military Departments

The Military Departments consist of the Army, Navy (of which the Marine Corps is a component), and the Air Force. In wartime, the U.S. Coast Guard becomes a special component of the Navy; otherwise, it is part of the Department of Homeland Security. The Military



Departments organize, staff, train, equip, and sustain America's military forces. When the President and Secretary of Defense determine that military action is required, these trained and ready forces are assigned to a Combatant Command responsible for conducting military operations.

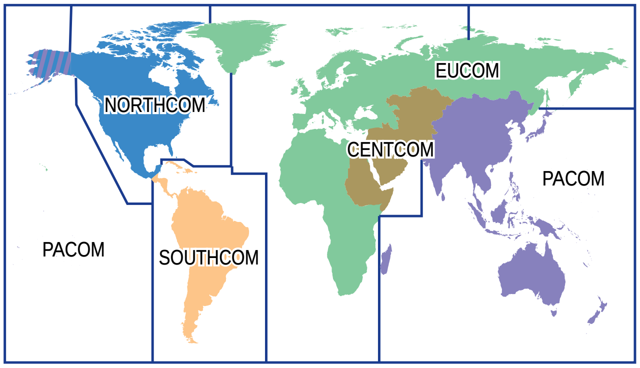
The Military Departments include Active Duty, Reserve, and National Guard forces. Active Duty forces are full-time military Service members. The Reserve, when ordered to active duty by the Congress, supports the Active forces. Reserve forces are an extension of the Active Duty personnel and perform similar jobs when called to active duty. They are also relied on to conduct counter-drug operations, provide disaster aid, and perform other peace-keeping missions. The National Guard has a unique dual mission with both federal and state responsibilities. In peacetime, the Guard is commanded by the governor of each respective state or territory, who can call the Guard into action during local or statewide emergencies, such as storms, drought, or civil disturbances. When ordered to active duty for mobilization or called into federal service for emergencies, units of the Guard are placed under operational control of the appropriate Military Department. The Guard and Reserve forces are recognized as an indispensable and integral part of the Nation's defense from the earliest days of a conflict.

Chairman of the Joint Chiefs of Staff

The Chairman of the Joint Chiefs of Staff is the principal military advisor to the President, the National Security Council, and the Secretary of Defense. The Chairman assists the President and the Secretary in providing for the strategic direction of the Armed Forces, including operations conducted by the Commanders of the Combatant Commands. As part of this responsibility, the Chairman also assists in the preparation of strategic plans and helps to ensure that plans conform to available resource levels projected by the Secretary of Defense.

Combatant Commands

Combatant Commands are responsible for conducting the Department's missions around the world. The Army, Navy, Air Force, and Marine Corps supply forces to these Commands.



Five Commands have specific mission objectives for their geographic area of responsibility, as shown in the map above:

- U.S. European Command (USEUCOM) is responsible for activities in Europe, Greenland, Russia, and most of Africa.
- U.S. Central Command (USCENTCOM) is responsible for the Middle East, eastern Africa, and several of the former Soviet republics. This Command is primarily responsible for conducting Operation Enduring Freedom in Afghanistan and Operation Iraqi Freedom.
- U.S. Pacific Command (USPACOM) is responsible for China, South and Southeast Asia, Australia, and the Pacific Ocean.
- U.S. Southern Command (USSOUTHCOM) is responsible for Central and South America, and the Caribbean.
- U.S. Northern Command (USNORTHCOM) is responsible for North America including Canada and Mexico.

In addition, four Commands have specified worldwide mission responsibilities focused on a particular function(s):

- U.S. Strategic Command provides global deterrence capabilities and synchronizes Department efforts to combat weapons of mass destruction worldwide.
- U.S. Special Operations Command leads, plans, synchronizes and, as directed, executes global operations against terrorist networks.
- U.S. Transportation Command moves military equipment, supplies, and personnel around the world in support of operations.
- U.S. Joint Forces Command develops concepts for joint warfighting.

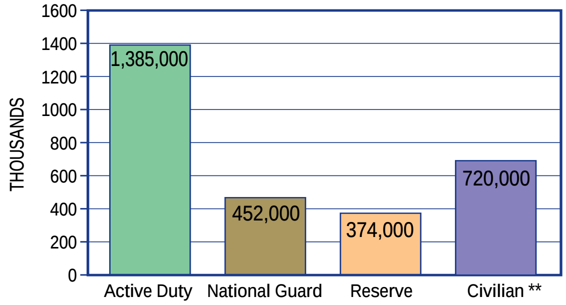
Defense Agencies and the Department Field Activities

Defense Agencies and the Department Field Activities provide support services commonly used throughout the Department. For instance, the Defense Finance and Accounting Service provides accounting services, contractor and vendor payments, and payroll services; and the Defense Logistics Agency provides logistics support and supplies to all Department activities.

Resources

To provide Americans with the highest level of national security, the Department employs nearly 1.4 million men and women on Active Duty, almost 826,000 in the Reserve and National Guard, and approximately 720,000 civilians. Together, these men and women work daily to protect U.S. interests around the world.

MILITARY AND CIVILIAN PERSONNEL



*** Source: Defense Civilian Personnel Data System, as of September 30, 2006.*

The Department's worldwide infrastructure includes nearly 600,000 facilities (buildings, structures, and utilities) located at more than 3,700 sites around the world, and nearly 30 million acres. To protect the security of the United States, the Department uses approximately 250,000 vehicles, 13,000 aircraft, and 500 oceangoing vessels.

Analysis of Financial Statements and Stewardship Information

The Department's six principal financial statements include a consolidated Balance Sheet along with statements of: Net Cost; Net Position; Budgetary Resources; Financing; and Custodial Activity. These statements reflect the combined financial posture of the Department and include both the proprietary (federal accounting standards) and budgetary resources of the Department.

The Department's financial management environment is complex and diverse. Its FY 2006 financial statements included $1.4 trillion in assets and nearly $2 trillion in liabilities. In FY 2006, the Department obtained an audit opinion on the Department-wide financial statements and its nine major reporting components, which include the Military Retirement Fund, the Medicare-Eligible Retiree Health Care Fund, the U.S. Army Corps of Engineers, and the general funds and working capital funds for the Army, Air Force, and Navy.

Of those, only the Military Retirement Fund received an unqualified audit opinion, meaning that the financial statements are presented fairly, in all material respects. The Military Retirement Fund accounts for 15 percent of the Department-wide assets and 49 percent of the liabilities.

The Medicare-Eligible Retiree Health Care Fund, which accounts for 6 percent of the Department's assets and 28 percent of its liabilities, received a qualified opinion, which means that except for certain

conditions, the financial statements meet the standards for an unqualified opinion as described above.

Overall, the Department (to include the remaining seven major reporting components) expects to receive a disclaimer of opinion from its auditor for FY 2006, which means the financial statements are not auditable.

The Department prepares statements for many of its smaller entities that are rolled into the overall consolidated financial statements and identified as "Other Defense Organizations." Some of these smaller entities are subject to audit each year. Five organizations within this group achieved unqualified audit opinions in FY 2006: the Defense Finance and Accounting Service, the Defense Contract Audit Agency, the Defense Commissary Agency, the Chemical Biological Defense Program, and the Defense Threat Reduction Agency. In addition, at the Department-wide level, the Department received favorable audit reviews for the third consecutive year on three significant financial statement items in FY 2006: (1) Investments, (2) Federal Employees' Compensation Act Liabilities, and (3) Appropriations Received.

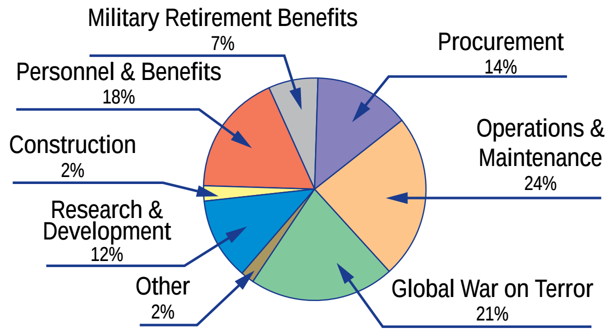
As a result of its financial improvement efforts, 15 percent of the Department's assets and 49 percent of its liabilities received clean audit results in FY 2006. The Department's financial statements for FY 2006 are presented in their entirety in Section 3: Financial Information. A summary of results is provided below.

Financial Analysis

In general, the financial statements of the Department show that the short-term financial outlook of the Department is stable. While needing to address priorities and seek supplementary funds from Congress due primarily to the Global War on Terror, the mission of the Department is being achieved. Short-term financial indicators reveal the Department's ability to satisfy immediate objectives while the long-term financial outlook is impacted primarily by future military retirement benefits.

During FY 2006, the Department received $594.7 billion in appropriations from the Congress and invested budget resources in the following general areas, as shown in the chart below. The Department, the federal government's single largest agency, receives more than half the discretionary amount of the federal budget.

FY 2006 Budget Allocation



As a result of these investments in people, infrastructure, operations, and technologies, the Department continues to defend the national interests. For example, during FY 2006 the Department reduced the foothold of terrorism, assisted in establishing the Iraqi government, provided humanitarian aid for victims of natural disasters, and continued improving financial accountability.

The complete picture of the Department's financial information shows several trends and insights into the financial health of the organization.

- The financial results of the Department reflect asset growth of 13 percent over the past 3 years, resulting from an increase in funds available, and investments for long-term liabilities and military equipment.
- Concurrent to the growth in assets, liabilities have increased nearly 15 percent primarily due to the long-term liability increases for military retirement benefits.

- The Department's net position increased 16 percent over the past 3 years. This increase is due primarily to the timing of a $68 billion supplemental appropriation for the Global War on Terror late in the fiscal year. The net position is projected to return to previous levels by the end of FY 2007 as the supplemental appropriation is executed.
- Departmental costs changes over the past 3 years are mainly driven by military retirement benefit costs, Global War on Terror costs, and depreciation expense on military equipment.

Long-Term Liabilities Related to Military Retirement Benefits

Eighty-three percent of long-term military retirement benefit liabilities are not currently funded. The Department has a sound investment strategy to address the military retirement benefits requirement. Based on current projections, unfunded liabilities in the Military Retirement Fund will be fully funded in 2033 and the Medicare-Eligible Retiree Healthcare Fund in 2041.

Military Equipment

The net value of military equipment increased $21 billion over the past 3 years primarily due to a change in valuation method. The baseline of $345 billion in book value is now accurately established and the Department is well on its way to improved financial health in this area.

Real Property

The Department's $100 billion in real property is an increase in 3 percent over the past 3 years. This is due to efforts to accurately identify and report a complete real property inventory.

Environmental Liabilities

Environmental liabilities of $68 billion is an increase of 8 percent over the past 3 years. This is due to Departmental efforts to improve estimates and its environmental liabilities inventory. Future challenges will be affected by the impact of valuations at overseas locations, buried munitions, base closure, cleanup, and enforcement of the standards for asbestos.

Improving the Department's Financial Management

The Financial Improvement and Audit Readiness plan *(http://www.dod.mil/comptroller/FIAR/index.html)* charts financial management transformation for the Department. It provides the construct within which sound financial management can mature and evolve. The Financial Improvement and Audit Readiness (FIAR) plan targets problems arising from weak or nonexistent internal controls, incomplete and inaccurate information, and systems that cannot properly process data and information. Financial management improvement efforts proceed primarily along two tracks:

- Improving the Department's financial health by streamlining procedures, improving the timeliness and availability of financial information, and capturing more relevant information.
- Preparing the Components for financial statement audits (e.g., testing internal controls).

Fully integrated with other business transformation efforts, the plan ensures accountability and prioritizes financial management improvements. The 3 essential elements—integration, accountability, and prioritization—are interrelated.

The FIAR plan reflects integrated solutions:

- Individual Component financial improvement plans detail corrective actions to accomplish critical milestones in the FIAR plan. For example, the U.S. Army Corps of Engineers' financial statements are currently under audit. In addition, the Air Force is ready for an audit of its Fund Balance with Treasury

and Cash and Other Monetary Assets.

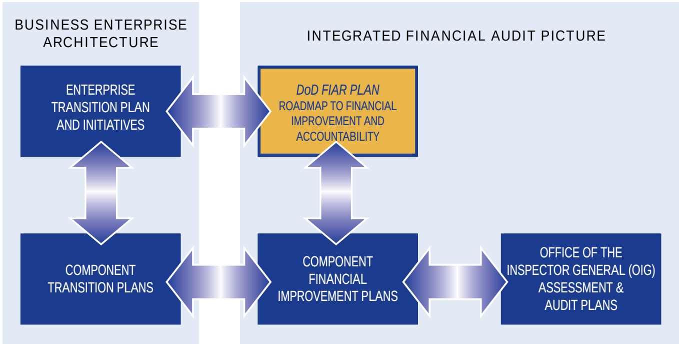
- Systems modifications and solutions managed under the Enterprise Transition Plan *(http://www.dod.mil/dbt/products/sept-06-bea_etp)* are closely aligned to FIAR efforts. The Department has thousands of programs and processes ranging from manual processing to computer-based management systems. Few interact with others, most do not meet congressionally-mandated requirements, and many fail to provide the level of reliability, accuracy, and timeliness demanded by today's complex business environment. Systems initiatives and solutions in the Enterprise Transition Plan eventually will provide the Department with effective and efficient Department-wide financial management systems that provide end-to-end tracking of financial transactions and produce fully auditable financial reports.
- The FIAR plan will enable the Department to comply with internal control requirements set forth by the Office of Management and Budget.
- The FIAR plan breaks down the Department's large number of assets and liabilities into auditable segments based on significant lines on the Department's Balance Sheet.

The FIAR plan sets priorities for the Department's financial management improvement efforts. The Department is focusing first on four items that represent 33 percent of its assets and 31 percent of its liabilities. The four focus areas include Military Equipment, Real Property, Medicare-Eligible Retiree Health Care Fund, and Environmental Liabilities. These lines represent some of the more significant Balance Sheet categories.

Finally, the FIAR plan ensures accountability:

- Progress toward completing key milestones is reported monthly to the Defense Business Systems Management Committee, chaired by the Deputy Secretary of Defense.
- Various metrics are used to gauge success.
- Accountability for accomplishing milestones will be included in the performance standards of personnel responsible for implementing the plan.
- Status of financial achievements are reported quarterly to the Office of Management and Budget.

The diagram below shows how the FIAR plan and Enterprise Transition Plan are integrated to focus efforts on improving the Department's financial management.



The financial portion of the Enterprise Transition Plan focuses on Financial Visibility *(http://www.dod.mil/dbt/priorities_financial.html)*, which is defined as having immediate access to accurate and reliable financial information (planning, programming, budgeting, accounting, and cost) in support of financial accountability and auditability, and facilitates effective decision-making throughout the Department. The Department's approach consists of the following key initiatives: Intragovernmental Transactions Initiative, Standard Financial Information Structure, and the U.S. Standard General Ledger.

Intragovernmental transactions involve sales, services, or transfers between two entities of the federal government. Generally accepted accounting principles require the elimination of intragovernmental balances from consolidated financial statements to prevent overstating accounts for intra- or inter-entity activity, or double counting. The Government Accountability Office cited the federal government's inability to adequately account for and reconcile intragovernmental activity and balances as a major impediment to rendering an opinion on the government-wide consolidated financial statements. In FY 2006, the Department developed a set of

requirements and initiated a demonstration system to enact standard processes, business rules, and data elements. This is the first step towards Department-wide deployment of this initiative to address intragovernmental transactions.

The Standard Financial Information Structure (SFIS) provides a common business language by using standardized terms throughout the Department. The common language ensures consistency in budgeting, accounting, financial reporting, and performance-based management. In FY 2006, the Department created the Standard Financial Information Structure Library *(http://www.dod.mil/dbt/sfis_resources.html)* to serve as the central repository for maintaining and exposing the Standard Financial Information Structure vocabulary to all Department business systems.

One of the requirements of the Federal Financial Management Improvement Act is that agencies' financial systems comply substantially with the U.S. Standard General Ledger at the transaction level. This means that agencies must conform to the Department of the Treasury's standards for recording transactions of the federal government accounting process. In FY 2006, the Department implemented an online U.S. Standard General Ledger Library in the Business Enterprise Architecture. This library breaks down the Department of the Treasury's general guidance into detailed transaction sets that link to specific business events, a capability that will facilitate standard account transaction postings using Standard Financial Information Structure data elements across the Department.

Based on these integrated plans, the Department made great progress in improving financial management in FY 2006. The Department completed nearly 80 percent of its Enterprise Transition Plan milestones and during fourth quarter, FY 2006 completed 94 percent of its FIAR Plan milestones. The Department's progress has not gone unrecognized. The Office of Management and Budget elevated the Department's progress rating for Improved Financial Performance under the President's Management Agenda to green. While progress is green, the Department remains red in status and remains on the Government Accountability Office's high risk list. The Government Accountability Office has issued two consecutive reports citing important business systems modernization progress, and the Comptroller General also has acknowledged publicly the Department's progress and approach.

Limitations of the Financial Statements

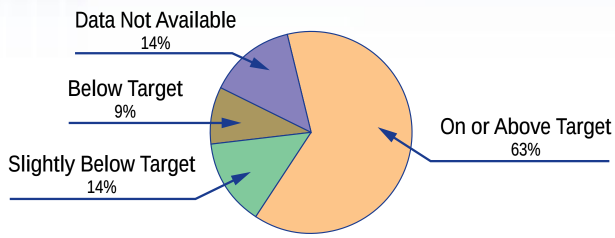
The principal financial statements have been prepared to report the financial position and results of operations of the Department of Defense, pursuant to the requirements of 31 U.S.C. 3515(b). The statements are prepared from accounting records of the Department in accordance with OMB Bulletin A-136 and to the extent possible generally accepted accounting principles. The statements, in addition to the financial reports, are used to monitor and control budgetary resources which are prepared from the same records. The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity.

Performance Objectives, Goals, and Results

The Department established four strategic goals for FY 2006, each with supporting performance measures. Overall, the Department succeeded in achieving its goals, as shown in the chart on the following page.

The goals and results for selected measures are presented with charts showing the Department's success in achieving its objectives in that area. Detailed performance information is presented in Section 2; Performance Information.

Summary of FY 2006 Performance Results (66 Metrics)

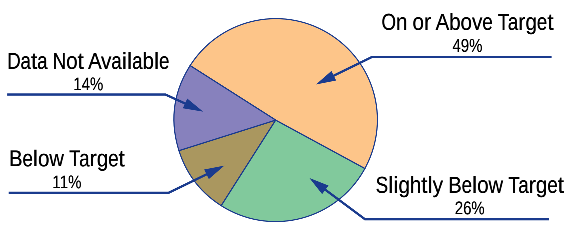


Strategic Goal 1: Balance Force Management Risk

This goal focuses on recruiting, retaining, training, and equipping America's military forces. Key components address issues such as the total strength of the Armed Forces, the number and educational level of Active and Reserve recruits, the ability of the Department to attract and retain critical skills, efforts to close the pay gap with the private sector for enlisted personnel, and the quality of health care provided to Service members and their families.

The chart below shows the performance ratings for the Balance Force Management Risk strategic goal.

Strategic Goal 1 Results Achieved for FY 2006 (35 Metrics)



FY 2006 results include:

- A very successful recruiting year—the Army, Navy, Marine Corps, and Air Force are expected to meet their annual targets. Nearly all recruits met or exceeded the desired educational and aptitude levels.
- High retention rates—the Marine Corps met its annual target.
- Closing the pay gap to within 3 percent between military enlisted and comparable civilian pay.
- Breaking the 90 percent threshold for the first time on overall satisfaction with health care appointments, exceeding the goal of 89 percent. Satisfaction with the Military Health Plan has risen 10 percent since FY 2002.
- The recruitment and retention of Service members in critical skill areas is improving. However, more improvement is needed. The Department is considering various incentives to attract and retain people with the skills that have high entrance standards or are crucial to combat readiness.

Strategic Goal 2: Balance Operational Risk

This goal focuses on achieving and maintaining operational superiority. Key goal components address issues such as incorporating lessons learned, effective real-time plans and operations, and integrating joint operations. By FY 2009, the Department will have a networked capability to seamlessly produce, update, and transition plans through crisis situations. The Department refers to this capability as "Net-Centricity." Net-centricity allows all DoD users and mission partners to share the information they need, when they need it, in a form they can understand and act on with confidence, and protects information from those who should not access it. Net-centricity is achieved through the realization of a networked environment (including infrastructure, systems, processes, and people) that enables a completely different approach to warfighting and business operations.

The Department is on or above target for all eight metrics for the Balance Operational Risk strategic goal. FY 2006 results indicate significant progress toward:

- Implementing the Global Force Management Data Initiative to monitor and provide comprehensive insight into U.S. forces that are available worldwide,

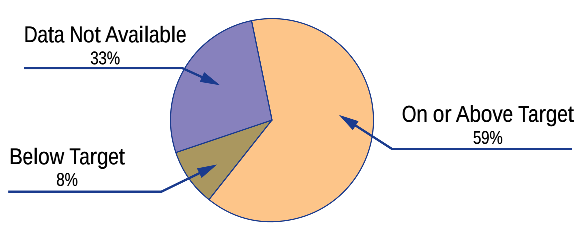
enabling the Department to allocate the right forces for specific missions, at the right place and time.
  - Adaptive Planning to produce war and contingency plans that are more timely and responsive to the current security environment.
  - Analytic Agenda Products that guide analysis through a set of common scenarios and data.
- Expanding the lessons learned program Department-wide. This includes incorporating the lessons learned from Operation Iraqi Freedom, the Department's response to Hurricane Katrina, and other recent actions.
- Continuing transformation to the joint force model to eliminate military "stovepipes" by seamlessly combining the Armed Forces' capabilities necessary to address a situation or event. The Capstone Concept for Joint Operations provides a broad description of how the future joint force will operate across the range of military operations 8 to 20 years in the future.

Strategic Goal 3: Balance Institutional Risk

This goal focuses on efforts to align the Department and its resources to support the warfighter. Key goal components address changing the way the Department conducts its daily business, such as controlling infrastructure costs, improving acquisition processes, and effectively managing its assets.

The chart below shows the performance ratings for the Balance Institutional Risk strategic goal.

Strategic Goal 3 Results Achieved for FY 2006 (12 Metrics)



FY 2006 results include:

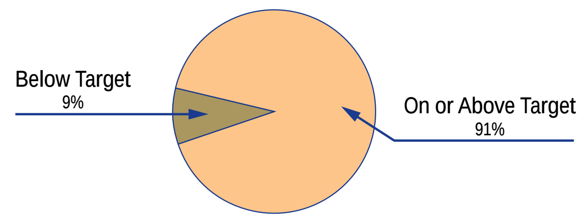
- Eliminating 29,245 inadequate housing units for military personnel, exceeding its target of 27,635. Since FY 2002, the percentage of inadequate housing units has dropped nearly one-third, from 59 to 40 percent. This issue is important enough to warrant a stand-alone initiative in the President's Management Agenda; as of September 30, 2006, the Department was rated green on both status and progress.
- Meeting its target to allocate 42 percent of its budget to infrastructure activities.
- Continuing efforts to achieve zero percent acquisition cost growth and reduce the time it takes to acquire major defense items and leverage new technologies.
- Strengthening budget guidance to estimate the direct cost of program priorities.

Strategic Goal 4: Balance Future Challenges Risks

This goal focuses on developing new, leading-edge capabilities to meet the challenges of tomorrow by rapidly converting innovative warfighting concepts from prototypes into fielded capabilities. Key components address defining and acquiring the skills required for the future, experimenting with new warfare concepts, enhancing its intelligence-gathering capabilities, and maintaining the Department's science and technology strengths.

The chart below shows the performance ratings for the Balance Future Challenges Risk strategic goal.

Strategic Goal 4 Results Achieved for FY 2006 (11 Metrics)



FY 2006 results include:

- Conducting numerous activities to improve the effectiveness of intelligence in military operations and for overall national security, including information sharing, developing a common human resources system for the intelligence components, and establishing standards for training, tradecraft, technology, architecture and operational tactics, techniques, and procedures.
- Achieving the goals for the Department's Defense Technology Objectives, which highlight specific technological advancement, the anticipated date the technology will be available, the specific benefits that should result from the technological advancement, and the funding required (and sources) to achieve the new capability.
- Establishing the Standing Joint Force Headquarters to ensure that in the event of a crisis, a team with the command structure and staff as well as functional and geographic expertise is already in place for rapid reaction with integrated employment of air, land, sea, and information forces.

Data Quality, Accuracy, and Reliability

To the greatest extent possible, the Department ensures that the performance data provided is quantifiable and verifiable by implementing internal management controls and responding to recommendations provided by the Department's Office of Inspector General, the Government Accountability Office, and others. Performance data for most quantifiable measures are generated as a result of the Department's operations. Survey satisfaction data is produced from statistically valid surveys. Accuracy measures come from validated automated systems and are reviewed periodically and verified for correctness. New metrics or metrics under development are subject to the same data quality requirements once the metric is established.

The Department recognizes its shortcomings in integrating performance and financial information caused by inadequate financial management systems. To address these problems and provide decision-makers with accurate, timely, and reliable financial data, the Department launched its Financial Improvement and Audit Readiness Plan and Enterprise Transition Plan in 2005. These plans were discussed earlier in this section.

The data in this report are the latest available at time of publication. In many cases, the data for FY 2006 are incomplete because of lengthy reporting cycles. Therefore, results are projected using partial year data. Incomplete data and projected results are noted for each metric as applicable. The FY 2007 Performance and Accountability Report will include final FY 2006 results and note any significant deviations from targeted and actual results.

Other Program Evaluations Conducted in FY 2006

The Department's Office of Inspector General reviewed many of the Department's activities. These reports also contain management's response and plans to address the issues identified in the reports. They may be viewed at http://www.dodig.osd.mil/. Click on Publications & Documents, then select Audits under the heading Reports.

The Government Accountability Office has reviewed a wide range of the Department's activities. The reports, which contain management's response and plans to address the issues identified in the reports, may be viewed at: http://www.gao.gov/ Click on Reports and Testimony, select browse by Agency, select Department of Defense, and select date range (October 1, 2005 to September 30, 2006 covers FY 2006).

Analysis of Systems, Controls, and Legal Compliance

Management Assurances

The Federal Managers' Financial Integrity Act (FMFIA) requires federal agencies to assess the effectiveness of internal management controls for program, operational, and administrative areas as well as accounting and financial management. Internal management controls are the organization, policies, and procedures that are considered the tools that help program and financial managers achieve results and safeguard the integrity of their programs. The program strengthens integrity and accountability within programs and operations, and:

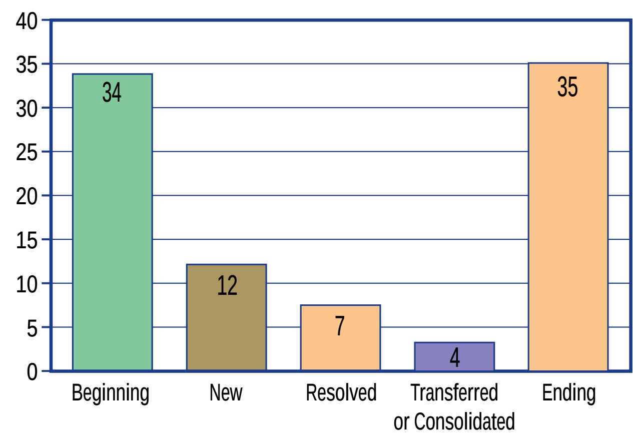
- Is critical for good government
- Demonstrates responsible stewardship over assets and resources
- Promotes high-quality, responsible leadership
- Enhances the sound delivery of services to customers
- Maximizes desired program outcomes

The Department assesses its internal management controls under a formalized program conducted throughout the Department, to include forward deployed units such as the Multi-National Forces - Iraq. Management's philosophy is that effective internal management controls are crucial to all processes and not just financial and accounting processes.

Using assessments according to the Office of Management and Budget Circular A-123, Management's Responsibility for Internal Control as the basis, the Department prepared the FY 2006 Annual Statement of Assurance, presented on the next page. The Department asserts that all Components have reported to the Secretary of Defense their individual statements of assurance over internal controls. The tables referenced in the statement appear in Section 4: Other Accompanying Information.

The Department uses management-conducted assessments with alternative reviews such as audit results as the source of weaknesses. In addition, the Department of Defense Office of Inspector General has previously identified 11 material weaknesses during its review of the Department, of which seven are covered in the Department's management weaknesses inventory, detailed in Section 4 of this report.

FY 2006 Material Weaknesses



Summary of Material Weaknesses and Corrective Actions

The Department continued an aggressive program of identifying, tracking, and resolving weaknesses in internal controls during FY 2006. Overall, the Department reported 12 new material weaknesses, corrected or consolidated 11, and ended FY 2006 with a total of 35, resulting in a net gain of one material weakness over FY 2005. Each weakness and their corrective action plans are discussed in detail in Section 4: Other Accompanying Information.

Annual Assurance Statement

DEPUTY SECRETARY OF DEFENSE
1010 DEFENSE PENTAGON
WASHINGTON, DC 20301-1010

November 15, 2006

The management of the Department of Defense remains committed to effective internal management controls, full compliance with established requirements, accurate financial reporting, and proper stewardship. Forthright reporting and prompt resolution of weaknesses are priorities.

For the overall statement of assurance pertaining to functional areas other than financial reporting, the Department can provide a qualified statement of reasonable assurance that internal management controls meet the objectives of the Federal Managers Financial Integrity Act and the Office of Management and Budget Circular A-123 except for the weaknesses listed in Section 4 of this report at Tables IIIa, IIIb, and IV. In addition, the Department is not compliant with system requirements of the Act as described in Section 4 of this report at Table V.

The assessments on the financial reporting areas were conducted in compliance with Circular A-123, Appendix A, under the oversight of the Department's Senior Assessment Team for the following areas.

- Fund Balance with Treasury
- Investments
- Real Property
- Military Equipment
- Federal Employee Compensation Act Liabilities
- Environmental Liabilities
- Medicare-Eligible Retiree Health Care Liabilities
- Appropriations Received

The Department can provide a qualified statement of assurance its internal management controls over financial reporting for the areas listed above, as of June 30, 2006, were operating effectively with the exception of the financial reporting weaknesses listed in Section 4 of this report at Table VI. The Department can provide no assurance outside these areas.

In 2006, the Department identified 12 new weaknesses and reduced the total number of outstanding weaknesses by 11, resulting in 35 outstanding weaknesses. Of the 35 weaknesses, five are classified as financial reporting weaknesses.

Internal Control Program Focus for FY 2006

On July 28, 2006, the Deputy Secretary of Defense announced a new √ ***CHECK IT*** Campaign to heighten awareness of the internal management control program across the Department. The core message of the campaign is that the Department counts on everyone to do his or her job right. As the campaign slogan states, "√ ***CHECK IT*** **because what gets checked gets done.**" The year-long campaign focuses on different functional areas each month, as shown in the chart below.

Month	√ *CHECK IT* Focus
2006	
August	Financial Management
September	Acquisition
October	Joint Military Operations
November	Personnel
December	Information Technology
2007	
January	Logistical Functions
February	Medical Functions
March	Financial Management
April	Safety
May	Military Operations
June	Intelligence and Security

Government leaders such as the Comptroller General, the Controller of the Office of Management and Budget, and the Under Secretary of Defense (Comptroller) have helped the Department by providing interviews. Stories featuring these interviews were broadcast internally within the Department of Defense on the Pentagon Channel, internationally on the American Forces Network, and are available on the DefenseLink, the Department's official website. Additionally, stories built around interviews, public service announcements, and posters are emailed directly to Component representatives throughout the Department in an effort to reach approximately three million Department personnel geographically dispersed in more than 140 countries. The goal is to reach everyone in the Department with this important message.

Statement of Assurance over Financial Reporting Process

The Department is using an incremental approach in implementing Circular A-123, Appendix A. At the beginning of FY 2006, the Deputy Secretary of Defense established a Senior Assessment Team composed of senior leaders as the governing body for the Department's Appendix A implementation. The team defines the scope of the assessments used within the Department, determines the Department's financial reporting weaknesses, and monitors the progress of corrective actions. In addition, certain Components, based on materiality, were required to establish Senior Assessment Teams that monitor the Component's Appendix A implementation process.

The Department issued guidance at the beginning of FY 2006 that prescribed procedures for conducting flow charts, risk assessments, and control analyses to promote consistency and comparability of data throughout the Department. In addition, the test plan guidance issued in March 2006 prescribed a standardized process for developing test plans, which included universe and sample size determination, independent testing, tolerance levels, and test methods.

The Department is leveraging its Financial Improvement and Audit Readiness (FIAR) plan for Appendix A implementation by using the resources and capabilities already established for the FIAR plan. The FIAR plan is the Department's path to audit readiness and an unqualified audit opinion. It describes major impediments identified by auditors and management and sets milestones for resolving problems affecting the accuracy, reliability, and timeliness of financial information. For process

solutions, the plan addresses known major deficiencies and captures work done or to be done by large Components in assessing their weaknesses and developing plans to overcome those weaknesses. The Department will continue to maximize resources by aligning its Appendix A efforts with the FIAR plan.

Training and Education

Management understands that training and education are crucial to the successful execution of the internal management control program and the conduct of adequate assessments. The Department conducted training for 21 of the 34 Components at locally-sponsored training workshops. In addition, the Department conducted a Department-wide conference attended by more than 200 representatives from all 34 Components.

To increase the education of managers and employees on the importance of internal management controls and effective assessment techniques, the Department is conducting a Department-wide survey of Department-sponsored schools to assess the extent to which training is already available for internal management controls. The results of the survey will be an indicator of how much additional course work for the internal management controls is needed at the Department of Defense schools.

Systems

The Federal Financial Management Improvement Act requires federal agencies to conform to the U.S. Government Standard General Ledger, comply with all applicable federal accounting standards, establish financial management systems that meet government-wide standards and requirements, and support full disclosure of federal financial data, including the costs of federal programs and activities.

The Department's Inspector General and the audit agencies within the Military Services have reported on the Department's failure to comply with the Act's requirements. The Department's inability to comply materially with the Act primarily results from structural problems related to legacy accounting systems that do not accurately account for both budgetary and proprietary activities. Quite simply, the Department does not have the systems and accounting structures in place to enable compliance.

To remedy these challenges, the Department of Defense has placed an unprecedented emphasis on reforming its financial management systems and accounting processes. Primarily through the Business Enterprise Architecture and the Enterprise Transition Plan, the Department is identifying the business capabilities and standards at the Department-wide level that will support compliance. The Standard Financial Information Structure and U.S. Standard General Ledger initiatives discussed earlier in this section are major steps toward achieving compliance with the Federal Financial Management Improvement Act.

Improper Payments Information Act Reporting

The Improper Payments Information Act of 2002, as implemented by the Office of Management and Budget, requires federal agencies to review all programs and activities annually and identify those that may be susceptible to significant erroneous payments.

The Department of Defense reports its progress in reducing erroneous payments to both the President and the Congress. The Department's FY 2006 review did not identify any programs or activities at risk for "significant erroneous payments" in accordance with the Office of Management and Budget's criteria (i.e., programs with erroneous payments exceeding both $10 million and 2.5 percent of program payments). During this review, however, the Department noted that civilian, commercial, and travel pay potentially were susceptible to erroneous payments in excess of $10 million. For FY 2006, the Department reports

on three high risk programs: military health benefits, military retirement, and military pay.

In accordance with guidance, the Department calculated statistically-valid estimates of erroneous payments and is implementing plans to reduce them within each of the six programs. Current estimates for FY 2006 improper payments are presented in the table below.

FY 2006 Estimated Improper Payments
Dollars in Millions

Program	Estimated $	Estimated %
Military Retirement	$48.8	0.1%
Travel Pay	$8.0	1.0%
Military Health Benefits	$140.0	2.0%
Military Pay	$65.9	0.1%
Civilian Pay	$62.8	0.1%
Commercial Pay	$550.0	0.2%

While the Department's overall improper payment percentage is quite low for the over $750 billion it pays each year to individuals, contractors, agencies, and other entities, the Department has numerous pre- and post-payment controls in place to minimize and eliminate improper payments. For further reporting details about these controls and the Department's Improper Payments Information Act reporting results, see Section 4: Other Accompanying Information.

Other Management Information, Initiatives, and Issues

President's Management Agenda

The President's Management Agenda has been inculcated throughout the Department and has made significant progress since implementation. Further information is available at http://www.results.gov. The President's Management Agenda identifies the following five government-wide initiatives:

- Electronic Government (e-Gov)
- Strategic Management of Human Capital
- Competitive Sourcing
- Improved Financial Performance
- Budget and Performance Integration

In addition, the President's Management Agenda includes the following four program initiatives that apply to the Department:

- Eliminating Improper Payments
- Real Property Management
- Coordination of Department of Veterans Affairs and Department of Defense Programs and Systems
- Privatization of Military Housing

As of September 30, 2006, the Department's grades were mixed:

Department Scorecard Results
(September 30, 2006)

Government-Wide Initiatives	Status Score	Progress Score
Electronic Government (e-Gov)	R	G
Strategic Management of Human Capital	Y	G
Competitive Sourcing	Y ↑	Y ↑
Improved Financial Performance	R	G ↑
Budget & Performance Integration	Y	G
Program Initiatives		
Eliminating Improper Payments Initiative	Y	G
Real Property Management Initiative	Y ↑	Y ↓
Coordination of VA and DoD Programs and Systems	Y	Y
Privatization of Military Housing *	G	G

G - SUCCESS   Y - MIXED RESULTS   R - FAILURE

Note: ↑↓ Changes in score since FY2005
** = Results as of June 30, 2006*

Following is a brief description of each initiative and actions that the Department has taken toward achieving the President's Management Agenda.

Electronic Government (E-Gov)

Goal: To ensure that the federal government's $60 billion annual investment in information technology (IT) is well spent.

Agencies are working to ensure that all major IT investments and projects are:

- Justified with strong business cases
- Completed within 10 percent of cost, schedule, and performance goals
- Secured properly and data is protected appropriately

The E-Gov initiative emphasizes the customer. The Department takes an active role in several government-wide initiatives, including SmartBUY, the Integrated Acquisition Environment, and various education and training initiatives.

As one example, the Department developed a multi-tiered Information Assurance workforce certification program in December 2005 which applies to both Department and contractor Information Assurance personnel. This program establishes technical and administrative training requirements; identifies specific commercial certifications applicable to the Department's military, civilian, and contractor Information Assurance support personnel; and requires the development of specific tracking and reporting capabilities to support certification/recertification efforts.

Strategic Management of Human Capital

Goal: To maintain a competent, motivated, and mission-ready workforce able to respond to emerging threats, now and in the future.

In May 2006, the Department issued its Human Capital Strategic Plan to guide and inform human resource policies, programs, and initiatives. Currently, the Department is re-evaluating and assessing its core mission and critical support occupations by: (1) workforce profile and trends, (2) Components' needs and requirements, and (3) geographical locations to ensure alignment with the capabilities listed in the Quadrennial Defense Review. This assessment will provide specific competency-focused results that will help support current and future workload requirements for the Department.

The Department began implementation of the National Security Personnel System on April 30, 2006, with the conversion of approximately 11,000 employees, supervisors, and managers to the pay band system and new performance management system. Between October 2006 and January 2007, 66,000 employees will be converted to the new system. The Department, however, remains enjoined by decision of the U.S. District Court from implementing the National Security Personnel System labor relations system and appeals process.

Improved Financial Performance

Goal: To ensure transparency over the Department's finances—having timely and reliable financial information on a regular, recurring basis and using that information to make informed decisions about agency or program management. Transparency means knowing the costs and results of the Department's programs and operations and being able to judge the best return on investment. Demonstrating fiscal accountability and achieving unqualified financial statements are good first steps. Ultimately, the Department will use more accurate, precise, and timely financial information in its day-to-day management.

In FY 2006, the Department released the Financial Improvement and Audit Readiness (FIAR) plan, which contains key milestone plans that include four focus areas and the Fund Balance with Treasury. The

key milestone plans incorporate the critical steps, by quarter, for obtaining favorable audit results, resolving related material weaknesses and other financial deficiencies, and providing improved financial data. The improved financial data will drive improvements in the Department's key management decisions. The FIAR plan also incorporates efficiency and effectiveness performance metrics for the four FY 2006 focus areas. As a result of the FIAR plan implementation, the Office of Management and Budget scored the Department as green for progress for the Improved Financial Performance initiative of the President's Management Agenda throughout FY 2006. While progress is green, the Department remains red in status and remains on the Government Accountability Office's high risk list.

Major FY 2006 accomplishments include:

- The United States Army Corps of Engineers' Civil Works financial statements are currently under audit.
- The Defense Logistics Agency has asserted that its contingent legal liabilities line item is ready for audit.
- The Department completed the baseline value of military equipment and reported this value in its financial statements.
- The Navy completed validation of its Nuclear and Conventional Ships and Submarines portion of its environmental liabilities, which account for 13.1 percent of the Department's environmental liabilities.
- The Navy and Air Force completed identification of the universe of units, facilities, property and/or operations where environmental liability issues have been identified.

Budget and Performance Integration

Goal: To improve program results and to ensure that performance is routinely considered in funding and management decisions.

During FY 2006, the Department formulated, justified, and defended its FY 2007 budget, which requested $439.3 billion in discretionary budget authority for FY 2007. The budget supports priorities established by the Secretary to fulfill the President's pledges to defeat global terrorism, restructure America's Armed Forces and global defense posture, develop and field advanced warfighting capabilities, and provide for the welfare of the forces. To develop the FY 2007 budget, the Department continued to implement the new Planning, Programming, Budgeting, and Execution System, refining the second year of the Department's 2-year budget. This process increases the effectiveness of the Department's resource allocation process by linking performance results to programming and budgeting decisions and placing additional emphasis on program execution.

The Department developed and submitted the FY 2006 Emergency Wartime Supplemental Request for funds to finance continuing military operations in Iraq and Afghanistan. The request was formulated, in large part, by calculating the costs, based on current cost and performance data, for specific performance elements (e.g., the deployment of specific units to the theater) and estimating the associated operational tempo.

In addition, the Department met its goal of using the Program Assessment Rating Tool to assess programs representing 80 percent of its resources in the FY 2007 President's Budget. Details about Department's results are presented in Section 2; Performance Information.

Competitive Sourcing

Goal: To help agencies become more results-oriented and effective through public-private competition subject to Office of Management and Budget Circular A-76, Performance of Commercial Activities.

The Department uses the A-76 process only when it makes military and economic sense to do so. Competition is the driving force within the American economy, resulting in improved quality, reduced cost, and rapid delivery of better products and services. The

Department continues to use the process of public-private competition to obtain services clearly identified as commercial to improve support to the warfighter and increase readiness. Alternatives to Circular A-76 are focused primarily on military-to-civilian conversions and high performing organizations, in accordance with section 337 of the National Defense Authorization Act of 2004 (Public Law 108-136). These alternatives also produce significant efficiencies, but the Department does not have systems necessary to quantify such efficiencies.

Public-private competition has produced significant savings for the Department. For competitions conducted between FY 2000 and FY 2006, the Department expects to produce savings (cost avoidance) of nearly $9.4 billion, regardless of who ultimately wins the competition. During FY 2006, the Department initiated competitions involving more than 7,000 positions with anticipated savings (cost avoidance) of $150 million.

Real Property Management

Goal: To help agencies efficiently manage the hundreds of billions of dollars in real property owned by the federal government.

The Department has developed and implemented a comprehensive plan to improve real property management with the ultimate goal of ensuring that the right assets are available, when and where needed, with the capabilities necessary to support the warfighter. Accurately capturing the real property inventory, and continuing to refine the performance measures that monitor how well the Department sustains, restores, and modernizes its facilities, are integral steps necessary to accomplish that goal. The Department's plan to monitor progress, identify and correct deficiencies, and address overall management of its real property includes:

- Increased visibility of assets under management through improved real property inventories.
- Application of requirements models that are based on accurate and auditable commercial benchmarks and tied directly to existing and forecasted assets.
- Standardization of performance targets across the Department through improved planning guidance.
- Implementation of mechanisms for continuous tracking of performance through the programming and budgeting cycle.
- Controlling the size of the Department footprint through incentives and robust demolition and disposal programs, including Base Realignment and Closure decisions.
- An up-to-date asset management plan that includes goals and timelines.
- Achieving full sustainment funding levels to prevent deterioration and loss of service life.
- Reaching a recapitalization rate that matches the expected service life of the assets under management, to prevent loss of effectiveness through obsolescence.

To improve asset accountability, the Department has developed a real property unique identification concept. All assets have a Department-wide unique identifier, allowing management and financial systems to better track environmental, operational, and financial data for real property. The Department's concept is being reviewed by industry and other federal agencies for use outside of the Department. Real property is a focus area of the Department's FIAR plan.

Eliminating Improper Payments

Goal: To strengthen financial management controls to better detect and prevent improper payments, enabling the Department to better ensure the taxpayer dollar is put to use as Congress intended.

Each year, the Department makes approximately $700 billion in payments to individuals and a variety of other entities. An improper payment occurs when the funds go to the wrong recipient, the recipient receives the incorrect amount of funds, or the recipient

receives payment for an ineligible service. Improper payments also include duplicate payments and payments for products and services not received.

The Department maintains a vigorous review process to identify and prevent duplicate vendor payments and ensure that program dollars are spent as intended. This review process includes pre- and post-payment reviews, continual enhancements to commercial payment systems to detect potential erroneous payments prior to disbursement, post-payment reviews of commercial payments within 180 days of disbursement, and continual review of purchase and travel card payments by the Office of Inspector General. The Department's efforts to eliminate improper payments are described in greater detail in Section 4: Other Accompanying Information.

Coordination of Department of Veterans Affairs and Department of Defense Programs and Systems

Goal: To ensure a seamless transition from Active Duty to veteran status, continuity of care, greater accuracy in forecasting patient population, and increased sharing of services to reduce costs and improve the quality of care.

Both the Department and the Department of Veterans Affairs (VA) operate comprehensive medical care programs for Active Duty military members and veterans. The Department and VA work together to find efficiencies and improve health care to beneficiaries. The Joint Executive Council and its subordinate Health Executive Council and Benefits Executive Council continue to pursue expanded opportunities to share health care resources between the two Departments. Currently, they are updating the Joint Strategic Plan for FY 2007, building on the successful completions of milestones and measures from the 2006 plan.

The plan includes goals, objectives, and performance metrics in the following areas:

- Leadership, commitment, and accountability
- High quality health care
- Seamless coordination of benefits
- Integrated information sharing
- Efficiency of operations
- Joint contingency/readiness capabilities

As part of the integrated information sharing goal, the Departments share a significant amount of data. The federal Health Information Exchange enables the transfer of protected electronic health information from the Department to VA at the time of a Service member's separation. On a monthly basis, the Department transmits to VA:

- Laboratory results
- Radiology results
- Outpatient pharmacy data
- Allergy information
- Discharge summaries
- Consult reports
- Admission, disposition and transfer information
- Elements of the standard ambulatory data records
- Demographic data on separated Service members

VA providers and benefits specialists access this data daily in their delivery of health care and claims adjudication. As of August 2006, the Department had electronically transmitted information to the exchange data repository on more than 3.6 million retired or discharged Service members. More than 1.9 million of these members went to VA for care or claims adjudication. In addition, in FY 2006 electronic pre- and post-deployment health assessment information was added to the information being sent to VA electronically. As of July 2006, more than 703,900 pre- and post-deployment health assessment forms were sent to VA, covering more than 580,000 separated Service members, and (deployed and now demobilized) Reserve and National Guard members.

Privatization of Military Housing

Goal: To eliminate inadequate family housing and increase the quality of life for Service members and their families.

The Department received green scores on the President's Management Agenda for both status and progress on this initiative. Leveraging the Department's resources with private sector capital revitalizes inadequate housing faster and at a lower lifecycle cost to the taxpayer than traditional construction. Since the end of 2000, when the Department privatized nearly 5,900 housing units, the Department has privatized almost 142,000 units, and plans to privatize a cumulative total of more than 186,000 units by the end of 2007. The Department tracks its progress in four categories: (1) elimination of inadequate housing units; (2) privatization of housing inventory; (3) average housing costs covered for Service members living in non-governmental housing; and (4) satisfaction of Service members with their housing choices.

Looking Forward: 2007 and Beyond

The 2006 Quadrennial Defense Review shapes the Department's future with a 20-year outlook by linking strategy to defense resources and encompassing four areas that drive capabilities development and force planning:

- Defeating terrorist networks
- Defending the homeland in depth
- Shaping the choices of countries at strategic crossroads
- Preventing hostile state or non-state actors from acquiring or using weapons of mass destruction

The 2006 Quadrennial Defense Review process also looked at all aspects of the Department to include:

- Programs and force size
- The right mix of capabilities
- Enablers such as logistics, space, and intelligence, surveillance, and reconnaissance
- Roles, missions, and organizations
- Manning and balancing the force
- Business practices and processes
- Department authorities

The 2006 Quadrennial Defense Review recognized that the United States is a Nation at war and is building on lessons learned from recent and ongoing operations in Iraq and Afghanistan. Senior Department leaders guided and participated in all aspects of the review to avoid "stove-piping" of issues and resource priorities. The Quadrennial Defense Review includes ideas from other government agencies, industry, allies, and partners. The Department consulted closely with Congress throughout the process.

A cross-cutting theme of the Quadrennial Defense Review is how America might help allies and partners develop their capacities to confront common security challenges. Experience in the war on terror has underscored the need for a changed defense establishment—one postured both for extended conflict and continuous transformation.

Based on the Quadrennial Defense Review results, the Department's senior leaders decided to refine the capstone force planning construct that translates the Department's strategy into guidance to shape and size military forces. This wartime construct, described in detail in the 2006 Quadrennial Defense Review, makes adjustments to better capture the realities of a long war by:

- Better defining the Department's responsibilities for homeland defense within a broader national framework.
- Giving greater emphasis to the war on terror and irregular warfare activities, including long-duration unconventional warfare, counter-terrorism, counter-insurgency, and military support for stabilization and reconstruction efforts.

- Accounting for, and drawing a distinction between, steady-state force demands and surge activities over multi-year periods.

At the same time, this wartime construct requires the capability to conduct multiple, overlapping wars. It calls for the forces and capabilities needed for deterrence, reflecting a shift from "one-size-fits-all" deterrence toward more flexible capabilities to deter advanced military powers, regional weapons of mass destruction states, or non-state terrorists.

The 2006 Quadrennial Defense Review provided new direction for accelerating the transformation of the Department to focus more on the needs of Combatant Commanders and to develop portfolios of joint capabilities rather than individual "stove-piped" programs. The 2006 Quadrennial Defense Review emphasizes the needs of the Combatant Commanders as the basis for programs and budgetary priorities.

This environment also places new demands on the Department's Total Force concept. Although the all-volunteer force has been a key to successful U.S. military operations over the past several decades, continued success in future missions is not preordained. The Total Force of Active and Reserve military, civilian, and contractor personnel must continue to develop the best mix of people equipped with the right skills needed by the Combatant Commanders. The Quadrennial Defense Review updates the Department's workforce management policies to guide investments in the force and improve the workforce's ability to adapt to new challenges.

The Quadrennial Defense Review and Department's FY 2007 Budget Submission

The 2006 Quadrennial Defense Review benefited from the change in the legislation mandating the review. By shifting the completion date of the review to coincide with the submission of the President's FY 2007 budget request, the Congress permitted the Department to "front-load" a limited number of initiatives into the budget submission for FY 2007, rather than waiting until the next full budget cycle. This Quadrennial Defense Review recommended a number of adjustments to align defense plans, policies, and programs with the broader strategic direction as "leading edge" measures in the President's Budget request for FY 2007. The Department will develop additional proposals for the FY 2008 budget submission.

Among the key programmatic decisions the Quadrennial Defense Review proposed to launch in FY 2007 are the following:

- Increasing Special Operations Forces by 15 percent and increasing the number of Special Forces Battalions by one-third to strengthen forces to defeat terrorist networks. U.S. Special Operations Command is establishing the Marine Corps Special Operations Command, an Air Force Unmanned Aerial Vehicle Squadron, and providing an increase of Navy SEAL teams. The Department also is expanding Psychological Operations and Civil Affairs units by 3,700 personnel, a 33 percent increase. Multi-purpose Army and Marine Corps ground forces are increasing their capabilities and capacity to conduct irregular warfare missions.
- Funding a $1.5 billion initiative over the next 5 years to develop broad-spectrum medical counter-measures against the threat of genetically engineered bio-terror agents. This will strengthen homeland defense and homeland security. Additional initiatives include developing advanced detection and deterrent technologies and facilitating full-scale civil-military exercises to improve interagency planning for complex homeland security contingencies.
- Developing a wider range of conventional and non-kinetic deterrent options while maintaining a robust nuclear deterrent to help shape the choices of countries at strategic crossroads, strengthen deterrence, and hedge against future strategic

uncertainty. It will convert a small number of Trident submarine-launched ballistic missiles for use in a conventional prompt global strike. The Department is increasing procurement of unmanned aerial vehicles to improve persistent surveillance, nearly doubling today's capacity. It is developing the next generation long-range strike systems, accelerating projected initial operational capability by almost two decades.

- Expanding its capabilities and forces for addressing the dangers posed by states that possess weapons of mass destruction and the possibility of terrorists gaining control of them. The U.S. Strategic Command is the lead Combatant Command for integrating and synchronizing efforts to combat weapons of mass destruction, providing a focal point for the Department's efforts. The Department also is establishing a deployable Joint Task Force headquarters for weapons of mass destruction elimination able to provide immediate command and control of forces for executing those missions.

Aligning Authority and Accountability through Joint Capability Portfolios

Most of the Department's resources are provided to the Military Services. This arrangement can lead to gaps and redundancies within capability areas as individual Service attempts to supply complete warfighting packages rather than organize to depend on capabilities provided by other Military Departments. To optimize the provision of capabilities for the joint warfighter, the Department is working to re-orient its processes around joint capability portfolios. In the acquisition realm, the Department has already instituted several joint capability reviews. These reviews look across major force programs to assess needed investments in specific capability portfolio areas such as integrated air and missile defense, land attack weapons, and electronic warfare.

The Quadrennial Defense Review used this type of portfolio approach to evaluate surveillance capabilities. The Department began by accounting for all of its current and planned surveillance capabilities and programs, which included a transparent review of capabilities at all levels of classification across the entire portfolio of assets. This review enabled decision-makers to make informed choices about how to reallocate resources among previously stove-piped programs to deliver needed capabilities to the joint force more rapidly and efficiently.

The Department is building on these initial efforts to integrate tasks, people, relationships, technologies, and associated resources more effectively across the Department's many activities. By shifting the focus from Service-specific programs to joint capabilities, the Department will be better positioned to understand the implications of investment and resource trade-offs among competing priorities. As a first step, the Department will manage four capability areas using a capability portfolio concept: Joint Command and Control, Joint Net-Centric Operations, Battlespace Awareness, and Joint Logistics. As the Department learns from experience and gains confidence in this approach, it plans to expand the concept to other capability areas.

Summary

Without question, reshaping the defense enterprise is difficult. The structures and processes developed over the past half-century were forged in the Cold War. However, the strategic landscape of the 21st century demands excellence across a much broader set of national security challenges. With change comes turmoil, and achieving a desired vision requires determination and perseverance within the Department. Cooperation with the Congress is vital. As the Department emphasizes agility, flexibility, responsiveness and effectiveness in the operational forces, its organizations, processes, and practices are changing to embody these characteristics to support the joint warfighter and America's Commander in Chief.

Section 2:
Performance Information

How the Department Evolved

1775 - The Army, Navy, and Marine Corps were established in concurrence with the American Revolution.

1789 - The War Department was established and was the precursor to what is now the Department of Defense.

1798 - The Department of the Navy, and the U.S. Coast Guard, were founded.

1947 – Congress established a civilian, Cabinet-level Secretary of Defense. The Department of the Air Force was created, the War Department was converted to the Department of the Army, and the three military departments of the Army, Navy and Air Force were placed under the direct control of the first Secretary of Defense.

1949 - the national defense structure was consolidated further, creating what we now know as the Department of Defense, and withdrawing cabinet-level status for the three Military Department Secretaries.

Overview

This overview describes the Department's strategic planning process and its methods for measuring performance. Due to the volume of information, the Department's printed Fiscal Year (FY) 2006 Performance and Accountability Report includes the results for selected performance measures under each strategic goal. The complete performance report includes a full discussion of each metric and is available on the Department's website (www.dod.mil/comptroller/par/fy2006/FY06PARSection2.pdf).

The Department's Quadrennial Defense Review serves as the Department's strategic plan. The Secretary's Annual Defense Report serves as the Department's annual performance plan. The 2001 Quadrennial Defense Review (www.defenselink.mil/pubs/qdr2001.pdf) and the 2005 Annual Defense Report (www.dod.mil/execsec/adr2005.pdf) set forth the performance objectives and goals that form the basis for the FY 2006 Performance and Accountablity Report. The most recent Quadrennial Defense Review, submitted to the Congress in February 2006, will form the basis for performance reporting for FYs 2007-2010 (www.defenselink.mil/qdr/report/Report20060203.pdf).

To demonstrate tangible benefits to the American public and to carefully monitor its own performance, the Department uses the performance management model depicted in the diagram below.

The performance model incorporates the following elements:

Mission

The mission of the Department of Defense is to provide the military forces needed to deter war and to protect the security of our country.

Strategic Objectives

The 2005 National Defense Strategy (www.defenselink.mil/news/Mar2005/d20050318nds1.pdf) established four strategic objectives for the Department of Defense:

- *Secure the United States from direct attack* by dissuading, deterring, and defeating those who seek to harm the U.S. directly, especially violent extremists with weapons of mass destruction.
- *Secure strategic access and retain global freedom of action* by promoting the security, prosperity, and freedom of action of the U.S. and its partners by securing access to key regions, lines of communication, and the global commons (i.e., international waters and airspace, space, cyberspace).
- *Strengthen alliances and partnerships* by expanding the community of nations that share principles and interests with the U.S. and help these partners increase their capacity to defend themselves and collectively meet challenges in the Nation's interest.
- *Establish favorable security conditions* by creating conditions conducive to a favorable international system by honoring America's security commitments and working with others to bring about a common appreciation of threats; a broad, secure and lasting peace; and bring about the steps required to protect against these threats.

Strategic Goals

The Department's resources to achieve these strategic objectives are limited and choices must be made between competing priorities by balancing the demands of the present against preparations for the future. Balancing priorities involves managing risk. The Department's risk management framework includes four dimensions that are described below. These dimensions form the basis for the Department's strategic goals.

- Force management risks are associated with managing military forces fulfilling the missions described in the National Defense Strategy. The primary concern is the ability to recruit, retain, train, and equip a ready force and sustain that readiness.

- Operational risks are associated with the current force executing the strategy successfully within acceptable human, material, financial, and strategic costs. The primary concern is the ability to achieve and maintain operational superiority.

- Institutional risks are associated with the capacity of new command, management, and business practices. The primary concern is to align the Department and its resources to support the warfighter.

- Future challenges risks are those associated with the Department's capacity to execute future missions. The primary concern is to ensure success against an array of prospective future challengers.

Performance Goals and Measures

The following table lists each strategic goal, its supporting performance goals, and the associated measures and metrics. Results for the measures and metrics in *italics* appear later in this section of the report. Results for all of the measures and metrics appear in the web version of the report.

Strategic Goal	Performance Goals and Associated Measures and Metrics
1. Balance Force Management Risk—Recruit, Retain, Train, and Equip a Ready Force and Sustain Readiness	
1.1 Ensure Sustainable Military Tempo and Maintain Workforce Satisfaction • Personnel Tempo (PERSTEMPO) Across Occupational Groups • Personnel Tempo (PERSTEMPO) Standards Met • *Quality of Life Social Compact Improvement Index* • *Commitment to Military Life Index* • *Satisfaction with Access* • *Overall Satisfaction with Appointment* • *Satisfaction with Military Health Plan*	1.2 Maintain a Quality Workforce • *Active Component End Strength* • *Reserve Component Selected Reserve End Strength* • *Active Component Enlisted Recruiting Quantity* • *Reserve Component Enlisted Recruiting Quantity* • *Active Component Enlisted Recruiting Quality* • *Reserve Component Enlisted Recruiting Quality* • *Critical Skill Recruit Needs* • *Active Component Enlisted Retention Goal* • *Selected Reserve Component Enlisted Attrition* • *Manning Level of Critical Skills* • Retain Balanced Mix on Non-Commissioned Officer Grade/Experience
1.3 Maintain Reasonable Force Costs • Civilian Force Costs • Community Quality of Life Per Capita Cost • *Cost Per Enlisted Recruit—Active Component* • *Cost Per Enlisted Recruit—Reserve Component* • *Cost of Basic Training* • *Military Personnel Costs—Enlisted Pay Gap* • *Medical Cost Per Equivalent Life Per Month* • Primary Care Provider Productivity • Total Costs for Contractor Support	1.4 Shape the Force of the Future • *Military Human Resources Strategic Plan* • *Civilian Human Resources Strategic Plan* • *Civilian Recruiting Cycle Time* • *Implement New Reserve Component Management Paradigm (Continuum of Service)* • *Active Component/Reserve Component Force Mix* • Identify Future Critical Skills • Meeting Civilian Critical Fill Goals • Optimal Officer Career Plans
2. Balance Operational Risk—Achieve and Maintain Operational Superiority	
2.1 Maintain Force Readiness • *Adaptive Planning* • *Analytic Baselines* • *Operational Lessons Learned* • *Defense Readiness Reporting System Implementation*	2.2 Ensure Superior Capabilities Exist to Succeed • *Global Force Management* • *Theater Security Cooperation*
2.3 Align Forces Consistent with Strategic Priorities • *Joint Concepts*	2.4 Transition Forces Rapidly to Meet New Threats • *Operational Availability*
3. Balance Institutional Risk—Align the Organization and its Resources to Support the Warfighter	
3.1 Improve the Readiness and Quality of Key Facilities • Base Realignment and Closure • *Eliminate Inadequate Domestic Family Housing by 2007* • *Fund to a 67-Year Recapitalization Rate* • Restore Readiness of Key Facilities by 2010	3.2 Manage Overhead and Indirect Costs • *Reduce Percentage of the Department's Budget Spent on Infrastructure*
3.3 Realign Support to the Warfighter • *Reduce Customer Wait Time* • *Reduce Major Defense Acquisition Program Annual Rate of Acquisition Cost Growth* • *Reduce Major Defense Acquisition Program Acquisition Cycle Time* • *Reduce Major Defense Acquisition Program Operating and Support Cost Growth*	3.4 Streamline the Decision Process, Improve Financial Management, and Drive Acquisition Excellence • *Improve the Transparency of Component Submissions for Alignment of Program Review to Strategic Trades* • *Increase Visibility of Trade Space* • *Provide Explicit Guidance for Program and Budget Development*
4. Balance Future Challenges Risk—Execute Future Missions Successfully Against an Array of Prospective Challengers	
4.1 Define and Develop Transformational Capabilities • *Intelligence Activities* • *Global Net Enabled Information Sharing Environment* • *Defense Technology Objectives* • *Net-centric Solutions*	4.2 Define Skills and Competencies for the Future • *Intelligence Human Resources Systems* • *Strategic Transformation Appraisal*
4.3 Develop More Effective Organizations • *Enhance Homeland Defense* • *Establish a Standing Joint Force Headquarters* • *Transform the Department's Training*	4.4 Drive Innovative Joint Operations • *Experiment with New Warfare Concepts* • Science and Technology

Performance Results

During FY 2006, the Department effectively accomplished its mission, met its strategic objectives and goals, and met 63 percent of its performance goal measures as indicated in the table below.

Strategic Goal	Performance Goal (Number of Reported Measures)	Performance Rating and Number of Results			
		Met or Above Target	Slightly Below Target	Below Target	Data Not Available
1. Balance Force Management Risk—Recruit, Retain, Train, and Equip a Ready Force and Sustain Readiness	1.1 Ensure Sustainable Military Tempo and Maintain Workforce Satisfaction	2	2		3
	1.2 Maintain a Quality Workforce	4	3	3	1
	1.3 Maintain Reasonable Force Costs	5	3		1
	1.4 Shape the Force of the Future	6	1	1	
2. Balance Operational Risk—Achieve and Maintain Operational Superiority	2.1 Maintain Force Readiness	4			
	2.2 Ensure Superior Capabilities Exist to Succeed	2			
	2.3 Align Forces Consistent with Strategic Priorities	1			
	2.4 Transition Forces Rapidly to Meet New Threats	1			
3. Balance Institutional Risk—Align the Organization and its Resources to Support the Warfighter	3.1 Improve the Readiness and Quality of Key Facilities	3			1
	3.2 Manage Overhead and Indirect Costs	1			
	3.3 Realign Support to the Warfighter			1	3
	3.4 Streamline the Decision Process, Improve Financial Management, and Drive Acquisition Excellence	3			
4. Balance Future Challenges Risk—Execute Future Missions Successfully Against an Array of Prospective Challengers	4.1 Define and Develop Transformational Capabilities	4			
	4.2 Define Skills and Competencies for the Future	2			
	4.3 Develop More Effective Organizations	2		1	
	4.4 Drive Innovative Joint Operations	2			
Summary Results		42	9	6	9

The data in this report are the latest available at the time of publication. In many cases, FY 2006 data are incomplete due to timing and reporting cycles. Some results are presented as of the second or third quarter, and may include year-end projections based on these data. Nearly half of the Department's performance data are current as of the third quarter; another one-third is current as of the fourth quarter or the end of the year. The web version of the FY 2006 report includes the due date for final data for each measure. The FY 2007 Performance and Accountability Report will include final FY 2006 results. It also will identify significant deviations from targeted and actual results.

In FY 2005, the Department reported on 70 performance measures. Four of those measures were deleted from this report for the following reasons:

- The "TRICARE Prime Outpatient Market Share" measure was dropped because the results provided limited value.
- "Enhanced Planning Process" is now covered by the "Analytic Baselines" measure.
- "Link Defense Resources to Key Performance Goals" is covered by two metrics: "Improve the Transparency of Component Submissions for Alignment of Program Review to Strategic Trades" and "Provide Explicit Guidance for Program and Budget Development."
- "Support Acquisition Excellence Goals" is now covered by three measures that address various reductions in the Major Defense Acquisition Program.

Final results for FY 2005 for selected measures are presented in this section of the report; complete FY 2005 results for all measures are contained in the web version of this report.

Descriptions of each strategic goal and specific results for FY 2006 are presented below.

Strategic Goal 1:
Balance Force Management Risk - Recruit, Retain, Train, and Equip a Ready Force and Sustain Readiness

This goal focuses on the Department's efforts to support American forces and ensure they have what is required to defend the Nation today and in the years ahead. These performance measures address the human part of the defense equation—what information is helpful for the Department to manage its workforce properly and continue to attract and retain the best and the brightest and sustain the quality of the all-volunteer force. The Department uses a wide range of measures and indicators to monitor the "pulse" of the workforce and to ensure the Department meets its military objectives.

Performance Goal 1.1:
Ensure Sustainable Military Tempo and Maintain Workforce Satisfaction

This performance goal focuses on deployment of forces and factors that influence recruitment and retention decisions. The military lifestyle presents special challenges to family life. Overseas tours away from support networks, frequent moves that disrupt a spouse's career or a child's school routine, and long separations from family members test the strength of our military families everyday. Military Tempo measures, which track time away from home, continue to be collected. However, payment for excessive tempo has been suspended. The current payment requirements have been considered punitive in nature, do not reflect the Services' deployment patterns, and are not appropriate compensation for exceeding member expectations. The compensation for excessive deployment is being re-evaluated to be more Service-specific and appropriate.

The Department uses a variety of measures to gauge its success in making military life a desirable career path. Below are selected metrics.

Quality of Life and Commitment to Military Service Indices

Many factors contribute to an individual's decision to join and remain in a career field, but the "benefits" package is always a key consideration. To attract and maintain a quality workforce, the Department developed the Modernized Social Compact that outlines a 20-year strategy for Quality of Life support to ensure that programs and services keep pace with the changing needs of the transforming military. The Compact is designed to help Service members keep pace with the American standard of living, to recognize and facilitate changing demographics (for example, two-thirds of military families live off the installation), and meet expectations of military members and their families.

The Department uses the Quality of Life Social Compact Improvement Index to ensure that it provides support to families. The Index monitors eight key programs and services supporting military members and families: housing, Military OneSource (a one-stop website for military members and their families containing useful information on life issues), off-duty/voluntary education, financial readiness, child development, the Department's education activity, commissaries, and exchanges. Functional areas and metrics may be added or eliminated as data mature and priorities change. The Index will be cross-referenced with a metric that measures the Community Quality of Life Per Capita Cost to ensure that programs are provided at a level sufficient to meet the unique needs of military members and their families. The Department is analyzing results from the 2006 surveys.

The following table shows the Department's progress toward developing and meeting the standards represented by the Quality of Life Social Compact Improvement Index.

Quality of Life Social Compact Improvement Index					
Metric	FY 2002	FY 2003	FY 2004	FY 2005 Target/Actual	FY 2006 Target/Actual[A]
Trend data to monitor improvements in leading Quality of Life indicators	No historical data; new metric	Developed framework for index	Met or exceeded standards in 4 of 8 functional areas For 2 functional areas, some of the Department's Components met or exceeded standards Did not meet standards for 1 functional area Metric for 1 functional area was under development	Met or exceeded standards in 3 of 8 functional areas For 4 functional areas, some of the Department's Components met or exceeded standards Metric for 1 functional area was under review	Meet or exceed standards in 8 functional areas

[A] FY 2006 data will not be available until the first quarter of FY 2007.

The Department is developing a Commitment to Military Life Index to track the factors that influence and predict commitment to military service for Active, Guard, and Reserve members and spouses. Commitment is a primary predictor of a Service person's intention to remain in the military and is useful in making resource decisions. This index is modeled after an approach used in corporate America to measure employee commitment. A

complementary Index of Spousal Commitment to the Military is being developed to acknowledge the importance of both military and family factors in predicting commitment to the military.

The value of the Commitment Index will be to demonstrate the fluctuations and factors of commitment over time. The Commitment Index survey questions will be included in all surveys of Active Duty members, and once each year in a Reserve and Guard survey. The Index will gain meaning as the factors influencing commitment are tracked at different points in time. The data will be used in further research that will look at how commitment indicators are linked to actual reenlistment decisions. The survey instrument will be reviewed and updated as needed, and data will be cross-referenced with the Quality of Life Social Compact Improvement Index and Community Quality of Life Per Capita Cost metric.

Medical Care

Another factor that influences recruitment and retention is the quality of the health benefits offered to members. The Military Health System provides operational medicine, training, research and force health protection across the full range of military operations. It also delivers health care for the system's 9.2 million eligible beneficiaries, including Active, activated Reserve, and eligible family members, through direct and managed care programs. The Department uses three metrics to gauge the effectiveness of its medical programs: (1) satisfaction with access, (2) overall satisfaction with appointment, and (3) satisfaction with military health plan.

Access

Access is a significant factor in the overall satisfaction with medical care and an area for focused improvement. The Department measures satisfaction with access to appointments based on monthly customer satisfaction surveys aimed at individuals who had an outpatient medical visit at a Military Treatment Facility hospital or clinic during the previous month. The survey includes a question, "How would you rate the (clinic name) on ease of making this appointment by phone?" The Department computes the percentage of respondents (weighted by appropriate sampling weights) who answer "Good," "Very Good," or "Excellent" (on a scale from "Poor" to "Excellent"). Quarterly reports are available by Military Service branch. The table below shows the aggregate Military Health System score.

Satisfaction with Access

Metric	FY 2002	FY 2003	FY 2004	FY 2005 Target/Actual[A]	FY 2006 Target/Actual[B]
Satisfaction with access	80.8%	83.0%	81.8%	≥84% / 81.0%	≥84% / 80.6%

[A] Actual performance represents a weighted average for the entire fiscal year.
[B] FY 2006 data are estimated as of the second quarter.

Satisfaction with access decreased after the survey method changed from mail to telephone. A slight change was expected, but the size of the decrease raised concerns about access to the hospitals or clinics. Using other tools,

the Department conducted a review to determine whether this was an issue across-the-board for the Military Health System or was focused on Military Treatment Facilities. Two major areas ("getting needed care" and "getting care quickly") from the quarterly beneficiary survey showed that responses from most enrollees were at or near the norm. However, enrollees in the TRICARE Prime program, a program similar to a health maintenance organization, appear to be less satisfied. Part of the reason may be the priority given to the returning wounded, which forces the TRICARE Prime enrollees to seek care in the private sector while the Military Treatment Facilities are treating the returning wounded. As more appointments become available in the military hospitals and clinics for TRICARE Prime beneficiaries, the scores should improve.

Although performance to date for FY 2006 is below the goal, it is expected to continue to improve throughout the rest of the year. It is unlikely that the Department will achieve the goal for the year. Access to care is a very important issue for the Military Health System, and the Department will continue to monitor and take appropriate action as needed.

Appointment Satisfaction

The Department also looks at beneficiaries' overall satisfaction with their outpatient medical appointments at a Military Treatment Facility hospital or clinic during the month. Overall satisfaction with the appointment is affected by numerous factors during the visit, including the experience in getting an appointment, the wait time at the appointment, the interaction with the provider, and interactions with the pharmacy or ancillary services. This metric is based on a monthly customer satisfaction survey for individuals who had an outpatient medical visit during the previous month. The metric is based on Question 12 of the customer satisfaction survey, which asks: "All things considered, how satisfied were you with the (name of clinic) during this visit?"

The survey is conducted monthly and computes the percentage of respondents (weighted by appropriate sampling weights) who answer "Good," "Very Good," or "Excellent" (on a scale from "Poor" to "Excellent"). Results are based on the summation of data for all surveys completed by patients during the year. Although information is available by Military Service branch, the table below shows only an aggregate Military Health System score.

Overall Satisfaction With Appointment

Metric	FY 2002	FY 2003	FY 2004	FY 2005 Target/Actual[A]	FY 2006 Target/Actual[B]
Overall satisfaction with appointment	87.1%	88.4%	87.6%	≥ 89% / 88.8%	≥ 89% / 90.5%

[A] Actual performance represents a weighted average for the entire fiscal year.
[B] FY 2006 data are estimated as of the second quarter.

The FY 2006 performance has continued to exceed the goal for the Military Health System. Once individuals obtain an appointment, they are satisfied with the health care services they receive and the overall treatment by the staff. Although the survey method changed from a mailed survey to a phone-based survey in FY 2005, the surveys did not show any decline in overall satisfaction with the appointment. The Department expects the score at the end of the fiscal year to remain above the goal.

Satisfaction with Health Plan

Satisfaction with the "company" health plan is an important recruitment/retention consideration in virtually every career path, and the military is no different. This metric provides a key indicator of the performance of the Military Health System. This metric uses the following survey item: "We want to know your rating of all your experience with your health plan. Use any number from 0 to 10 where 0 is the worst health plan possible and 10 is the best health plan possible. How would you rate your health plan now?"

Satisfaction is measured as the percentage of respondents (weighted by appropriate sampling weights) who answer 8, 9, or 10. Currently, the results for the year are actually based on the respondents' interactions with the health system during the prior fiscal year. The table below shows that the Department has made steady improvements in health plan satisfaction rates since FY 2002.

Satisfaction with Military Health Plan					
Metric	FY 2002	FY 2003	FY 2004	FY 2005 Target/Actual[A]	FY 2006 Target/Actual[B]
Percentage satisfied with military health plan	46.5%	51.2%	53%	≥ 57% / 53%	≥ 57% / 56%

[A] Actual performance represents a weighted average for the entire year.
[B] FY 2006 data are final as of the third quarter.

Throughout FY 2006, eligible beneficiaries' satisfaction with the plan has improved. The results for each quarter of FY 2006 are above the comparable quarter for FY 2005. Issues with claims processing have been resolved, and development of the provider network is occurring smoothly. The next issue for focused improvement is access to care; the Department expects to make improvements that will have a positive impact on the beneficiaries' overall satisfaction with the plan.

Performance Goal 1.2: Maintain a Quality Workforce

This goal focuses on ensuring that the Department has the appropriate numbers and skill mix in its military forces. Metrics cover three broad categories: total strength, recruitment results, and retention results. The categories link together very closely; a shortfall or overage in one has implications for the other two.

Military Manpower

Two metrics track the total number of Active Component and Reserve Component forces available, or what the Department refers to as the end strength. End strength is the number of forces that are onboard at the end of the fiscal year to execute the Department's mission.

Active Components

The table below shows the end strength for the Active Components. The percentages beneath each figure indicate the percentage difference between the planned and actual end strength.

Active Component End Strength (in thousands)					
Service	FY 2002	FY 2003	FY 2004	FY 2005 Target/Actual	FY 2006 Target/Actual[A]
Army	486.5 (+1.4%)	499.3 (+4.0%)	499.5 (+3.6%)	502.4 / 492.7 (-1.9%)	512.4 / 496.4 (-3.1%)
Navy	383.1 (+1.9%)	382.2 (+1.7%)	373.2 (-0.2%)	365.9 / 362.9 (-0.8%)	352.7 / 353.5 (+0.2%)
Marine Corps	173.7 (+0.7%)	177.8 (+1.6%)	177.5 (+1.4%)	178.0 / 180.0 (+1.1%)	179.0 / 178.9 (-0.0%)
Air Force	368.3 (+2.6%)	375.1 (+4.4%)	376.6 (+4.8%)	359.7 / 353.7 (-1.7%)	357.4 / 352.6 (-1.3%)
[A] FY 2006 data are as of the third quarter.					

The Nation continued to operate in a state of national emergency due to the Global War on Terror. As a result, the Congress authorized end-strength increases during FY 2006 for the Army and Marine Corps. The Army's authorization was increased to 512,400. The Marine Corps' authorization was increased by 1,000. The Marine Corps reached its new authorization by the end of the third quarter. The Army began the fiscal year with 492,700 soldiers (short of the desired FY 2005 end strength), but expects to end FY 2006 just 1.9 percent short of its goal.

Leveraging technology and modernizing weapons platforms have helped achieve a reduction in manpower requirements. The Air Force is slightly below its authorized strength as of the third quarter and most likely will not meet its FY 2006 authorized strength. However, the Air Force plans to reduce strength by 23,200 in FY 2007; therefore, falling below the FY 2006 authorization is not a concern. The Navy had a 13,200 reduction in authorized strength in FY 2006 and ended the third quarter slightly above its FY 2006 authorized strength. In FY 2007, the Navy plans another strength reduction of 12,000. While both the Air Force and the Navy reduce strength levels, they are properly shaping the force using force-shaping tools such as moving qualified Service members into undermanned critical skills areas and applying high accession and retention standards to ensure a highly qualified workforce with the right people, in the right jobs, at the right time.

Reserve Components

At the end of the third quarter, four Department Components (Army National Guard, Army Reserve, Navy Reserve, and Air National Guard) were below their targets. The Navy Reserve will close FY 2006 under strength due to recruiting shortfalls and fewer re-enlistments. The shortfall in the two Army Reserve Components was attributed to a strong economy, which results in fewer individuals joining the Reserve.

Based on current projections, the Reserve forces should achieve the following strength levels:

Reserve Component Selected Reserve End Strength (numbers in thousands)					
Reserve Component	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006 Target/Actual[A]
Army National Guard	351.1 (+0.3%)	351.1 (+0.3%)	342.9 (-2.0%)	333.2 (-4.8%)	350.0 / 340.4 (-2.7%)
Army Reserve	206.7 (+0.8%)	211.9 (+3.4%)	204.1 (-0.4%)	189.0 (-7.8%)	205.0/189.8 (-7.4%)
Navy Reserve	88.0 (+1.1%)	88.2 (+0.4%)	82.6 (-3.9%)	76.5 (-8.3%)	73.1 / 70.3 (-3.8%)
Marine Corps Reserve	39.9 (+0.9%)	41.0 (+3.8%)	39.7 (+0.1%)	39.9 (+0.9%)	39.6 / 39.5 (-0.3%)
Air National Guard	112.1 (+3.4%)	108.1 (+1.4%)	106.7 (-0.2%)	106.4 (-0.3%)	106.8 / 105.2 (-1.5%)
Air Force Reserve	76.6 (+2.6%)	74.8 (-1.1%)	75.3 (-0.6%)	75.8 (-0.4%)	74.0 / 74.7 (+1.0%)
[A] FY 2006 data are final as of the third quarter.					

Recruitment

The Department uses several metrics to provide insight into the outcomes of its recruiting efforts. The first set answers the question: "Did the Department meet its annual recruiting goals?" The second set ranks the educational level and aptitude of the recruits. The third set examines the Department's success in recruiting individuals with critical skills.

Number of Recruits – Active Components

All Active Components met their third quarter recruiting goals and are expected to meet their year-end recruiting goals for FY 2006.

Active Component Enlisted Recruiting Quantity (numbers in thousands)					
Metric	FY 2002	FY 2003	FY 2004	FY 2005 Target/Actual	FY 2006 Target/Actual[A]
Number of enlisted Active Component accessions	196.5	184.9	182.6	169.5 / 163.3	179.7 / 120.1
[A] FY 2006 data are final as of the third quarter.					

Number of Recruits – Reserve Components

All Reserve Components, except Navy Reserve and Air National Guard, met their recruiting goals through the end of the third quarter in FY 2006. The strong economy and the pressures of the Global War on Terror have created

a lower propensity among Service-eligible young people to join and a decreased desire by those who typically influence potential recruits to consider military service. Enhanced recruiting and retention incentives have helped.

Reserve Component Enlisted Recruiting Quantity (numbers in thousands)					
Metric	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006 Target/Actual[A]
Number of enlisted Reserve Component accessions	147.1	133.1	118.2	141.1	141.1 / 101.2
[A] FY 2006 data are final as of the third quarter.					

Educational Levels and Aptitude

Aptitude test results and education levels correlate closely to job performance for both Active and Reserve members. All military enlisted applicants (Active and Reserve) take the Armed Services Vocational Aptitude Battery exam, which includes the Armed Forces Qualification Test. This test measures math and verbal skills, which directly correlate with trainability and on-the-job performance. The table below shows how test percentiles are grouped into categories:

Armed Forces Qualification Test Categories and Corresponding Percentile Score Ranges	
Category	Percentile Score Range
I	93–99
II	65–92
IIIA	50–64
IIIB	31–49
IV	10–30
V	1–9

Those who score at or above the 50th percentile are ranked in categories I-IIIA. The Department values these higher-aptitude recruits because their training and job performance are superior to those in the lower groupings. The Department also values recruits with high school diplomas because years of research and experience demonstrate that high school graduates are more likely to complete their initial 3 years of enlistment.

Quality benchmarks for recruiting were established in 1992 based on a study conducted jointly by the Department and the National Academy of Sciences. The study produced a model linking recruit quality and recruiting resources to the job performance of enlistees. From this model, the Department derived its minimum acceptable quality thresholds for Active and Reserve members as follows:

- 90 percent with high school diplomas or equivalent
- 60 percent in aptitude test categories I–IIIA
- Not more than 4 percent in aptitude test category IV

Adhering to these benchmarks reduces personnel and training costs, while ensuring that the force meets high performance standards.

As the following tables show, the quality of Active and Reserve Component recruits is fairly consistent from year to year. Three of the four Active Components met their quality goals, while the Army missed its high school diploma goal. Most Reserve Components have met the quality standards in their recruiting efforts through the end of the third quarter. It appears the Navy Reserve missed its target due to challenges in reporting. The Navy is working on a solution. While the Army National Guard missed its targets slightly as of the end of the third quarter, fourth quarter trends suggest that it may meet the goal of 90 percent recruits with high school diplomas and less than 4 percent in the Armed Forces Qualification Test category IV.

Active Component Enlisted Recruiting Quality

Category	FY 2002	FY 2003	FY 2004	FY 2005 Target/Actual	FY 2006 Target/Actual[A]
Percentage of recruits holding high school diplomas	94%	95%	95%	>90% / 93%	>90% / 92%
Percentage of recruits in Armed Forces Qualification Test categories I–IIIA	70%	72%	73%	>60% / 70%	>60% / 70%
Percentage of recruits in category IV	0.7%	0.2%	0.3%	<4% /1.9%	<4% / 1.5%

[A] FY 2006 data are final as of the third quarter.

Reserve Component Enlisted Recruiting Quality

Metric	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006 Target/Actual[A]
Percentage of recruits holding high school diplomas	89%	87%	87%[B]	85%	>90% /89%
Percentage of recruits in Armed Forces Qualification Test categories I–IIIA	66%	66%	66b%	63%	>60% / 61%
Percentage of recruits in test category IV	1.1%	1.5%	2.0%	3%	<4% / 4%

[A] The FY 2006 data are final as of the third quarter.
[B] Excludes Air National Guard.

Critical Skills

The third set of recruitment metrics evaluates the Department's success in attracting recruits with critical skills that are in high demand. This metric captures the fill rate for enlisted skills that the Services consider most critical for recruitment emphasis, such as linguists, explosive ordinance disposal technicians, and military police. Positions requiring these skills are difficult to fill, either because they are viewed as undesirable or dangerous, or persons with the needed specialty skills are not readily available.

To obtain these skills, the Department may provide enlistment bonuses, incentives to recruiters, etc. Currently, the metric is applied only to Active Duty enlisted recruits.

The exact fill rate for each skill is measured and each Service is rated based on the recruit rate for its lowest skill rating. The Department uses the following criteria for evaluating overall unit readiness with respect to skill match (the categories and percentages indicate whether unit personnel have the skills to fit the unit's missions):

- C1—Fully mission capable 85% or above
- C2—Mostly mission capable 75% to 84%
- C3—Major parts mission capable 65% to 74%
- C4—Some parts mission capable 64% and below

The "C" rating, short for capability rating, focuses on the weakest link in the chain. For example, if a unit needs five critical skills to perform its mission successfully, and only four of the five are filled at a rate of 85 percent or more, the unit's "C" rating is based on the fifth skill fill rate. If it is filled at only 60 percent then the unit as a whole receives the lowest rating of C4.

The following tables show the overall fill rates for designated skills and how the data breaks down by Active Component. As of the third quarter, the Air Force met the target, but the other Services did not.

Critical Skill Recruit Needs					
Metric	FY 2002	FY 2003	FY 2004	FY 2005 Target/Actual	FY 2006 Target/Actual[A]
Percentage of designated skill positions filled	No historical data; new metric	No historical data; new metric	95%	95% fill rate / 65%	95% fill rate / 84%
[A] FY 2006 data are final as of the third quarter.					

Retention

The ability of the Department to retain Active and Reserve forces in certain numbers at certain career levels is a key driver that has both staffing and budget repercussions. Poor retention rates require greater recruiting efforts and increased funding to train new Service members.

Active Components

The table below shows that the Active Components continue to have excellent retention rates and are meeting or exceeding year-to-date goals. The figures reflect reenlistment numbers as of the end of the third quarter; the Marine Corps has already met its annual goal. The other Services are expected to meet their annual reenlistment goals by the end of the fiscal year.

Active Component Enlisted Retention Goal (numbers in thousands)					
Service[A]	FY 2002	FY 2003	FY 2004	FY 2005 Target/Actual	FY 2006 Target/Actual[B]
Army					
Initial	19.4	19.8 / 21.8	24.9	26.9 / 27.8	26.5 / 24.5
Mid-career	23.1	19.5	21.1	23.8 / 24.4	24.5 / 19.6
Career	15.7	12.8	14.0	13.5 / 17.3	13.2 / 12.4
Total	58.2	54.2	60.0	64.2 / 69.5	64.2 / 56.5
Navy[C]					
Zone A	59%	62%	54%	53% / 52%	15.0 / 11.2
Zone B	75%	77%	70%	69% / 63%	8.0 / 6.5
Zone C	87%	88%	87%	85% / 85%	4.0 / 3.6
Total					27.0 / 21.3
Marine Corps					
First term	6.1	6.0	6.0	5.9 / 6.2	5.9 / 5.9
Subsequent	7.3	5.8	7.7	5.1 / 7.0	6.3 / 6.4
Total	13.3	11.8	13.7	11.0 / 13.1	12.1 / 12.3
Air Force[C]					
Zone A	72%	61%	63%	51% / 41%	19.4 / 14.8
Zone B	78%	73%	70%	71% / 70%	9.3 / 7.8
Zone C	95%	95%	97%	88% / 89%	6.2 / 5.2
Total					31.9 / 27.8

[A] Definitions by years of service:
Army: Mid-career—7 to 10; career—10 or more
Navy: Zone B—6 to 10; Zone C—10 to 14
Air Force: Zone B—6 to 10; Zone C—10 to 14
Marine Corps: First term—Marines on their initial contract who are interested in reenlisting during their Expiration of Active Service fiscal year; Subsequent—Marines in the ranks of sergeant, staff sergeant, and gunnery sergeant.
[B] FY 2006 actual data are final as of the third quarter. Target is the annual retention goal.
[C] The Navy and Air Force in FY 2005 and prior years tracked retention as a percentage of the target. To enhance consistency in the reporting process across the Department, the Navy and Air Force began reporting the actual number of reenlistments in FY 2006.

Reserve Components

To assess retention trends in the Reserve Components, the Department uses attrition rather than retention rates. Attrition is computed by dividing total losses from the Selected Reserve of a specific Component for a fiscal year by the average personnel strength of that Component's Selected Reserve for that year. This metric is preferable to retention rates for two reasons: (1) only a small portion of the Reserve Component population is eligible for reenlistment during any given year, and (2) the Reserve Components have different business practices than the Active Components due mainly to the lack of mobility of reservists.

The table below shows that Reserve Component attrition overall is within anticipated limits. Reserve Component Enlisted attrition is generally lower when compared to third quarter results from the prior year. Components anticipate achieving targets at year-end due to Command emphasis on providing support to Reserve members and their families.

Selected Reserve Component Enlisted Attrition Ceiling					
Selected Reserve Component	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006 Target/Actual[A]
Army National Guard	20.6%	18.1%	18.6%	20.2%	19.5% / 14.3%
Army Reserve	24.6%	22.1%	22.6%	23.4%	28.6% / 16.1%
Navy Reserve	26.5%	26.5%	28.2%	31.2%	36.0% / 26.0.%
Marine Corps Reserve	26.0%	21.4%	26.3%	22.1%	30.0% / 18.9%
Air National Guard	7.3%	12.7%	11.5%	10.2%	12.0% / 8.4%
Air Force Reserve	8.7%	17.0%	13.6%	14.7%	18.0% / 11.0%

[A] FY 2006 data are estimated as of the third quarter.

Critical Skills

The Department also is developing a way to measure its effectiveness at retaining critical military skills. To be designated as "critical," a skill must meet two tests: (1) it must be short of its targeted manning level, and (2) it must be critical to the Service's mission. As a first step, the Department established a common definition and metric to monitor critical skills across the Services.

A skill shortage may occur when fewer individuals are assigned than are authorized (quantitative) or when the average experience is substantially different from the desired experience (qualitative). These shortages are actual, projected, or have a past trend of historical shortages. To be considered mission critical, a skill must meet at least one of the following criteria:

- Require notably above-average training or replacement costs
- Be in high demand in the civilian sector
- Present a recruiting challenge
- Be crucial to combat readiness
- Be a low-density, high-demand skill

The Service's overall rating can be no higher than its lowest-rated critical skill; the Department's score can be no higher than the lowest-rated Service.

The Department monitors each Service's ability to retain members in its top 10 critical skills using a stoplight scoring system. Overall, the Department and the individual Active Components are rated "Red" for critical skills. Only 10 of 40 (25 percent) designated skills achieved 95 percent or greater fill goal. A skill retention rate of 95 percent or greater is assessed "green", 85-94 percent "yellow," and 85 percent or less "red." Most critical skills require difficult training and very stringent prerequisites for continuation, and they are highly sought in both the private sector and among other government agencies.

Manning Level of Critical Skills					
End-State Metric	FY 2002	FY 2003	FY 2004	FY 2005 Target/Actual	FY 2006 Target/Actual[A]
Percentage of skills deemed critical for retention relative to a Department-wide benchmark	No historical data; new metric	Started to define critical skills Developed list of critical skills	Established common definitions for critical skills Tested data collection	Began tracking the metric during the second quarter FY 2005	>95% fill for all skills/ Overall Services rating: Red 25% of designated skills achieved 95% or more of goal
[A] FY 2006 data are final as of the third quarter.					

Performance Goal 1.3: Maintain Reasonable Force Costs

This goal focuses on the cost to maintain the military force necessary to fulfill the Department's mission. The term "force costs" refers to all the force-related activities that make up overall labor costs for the Department. Per capita costs for recruiting and basic training; civilian and contractor support costs; medical costs and Quality of Life initiatives; productivity of primary care providers; and the pay gap between private sector and military compensation that exists for enlisted personnel are measures that help the Department manage its labor costs. Several of these cost factors are described below.

Per Capita Costs to Recruit and Train

The cycle to recruit, train, and replace Service members is a major cost driver for force management. Two factors provide a rudimentary indicator of the price of replenishing the force over time: the average annual cost to recruit one new Service member and the cost to complete basic training per Service member. The cost per recruit tends to increase annually, while the cost of basic training has remained relatively stable. Each year, the Department enlists approximately 180,000 new recruits for the Active Components and 130,000 for the Reserve Components.

Recruiting Costs

The two tables below indicate the cost per Active and Reserve Component recruit along with indicators that track costs and trends over time. The cost of recruiting an Active or Reserve Component member is calculated by dividing a Service's total expenditures for enlisted recruiting by the total number of recruits. Recruiting expenditures include recruiting personnel compensation, enlistment bonuses, college funds, advertising, communications, recruiting support, and other resources within the recruiting Service.

The estimated cost per enlisted recruit in FY 2006 is below the FY 2003 - FY 2005 levels. The FY 2006 estimate does not include supplemental appropriations. These increased resources will be reflected in the FY 2008 President's Budget submission.

Reliable FY 2006 recruiting costs for the Reserve Components could not be determined. Changes in Component personnel procedures and system problems have made it difficult to determine the reliability and validity of the cost per enlisted recruit for the Reserve Components. The Department is actively pursuing a solution to this problem.

Cost Per Enlisted Recruit—Active Component (Constant FY 2006 Dollars)					
Metric	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006[A]
Cost per recruit	$14,901	$15,156	$15,153	$16,386	$14,845
[A] FY 2006 data are as of the FY 2007 President's Budget.					

Cost Per Enlisted Recruit—Reserve Component (Constant FY 2005 Dollars)					
Metric	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006 Target/Actual
Cost per recruit	$6,636	$7,773	$9,174	$10,012	2% variance from target /not available

Training Costs

Basic training encompasses the fundamental introduction and indoctrination provided to enlisted recruits. Performance and production targets are driven by the number of recruits and vary by Service and year. Basic training costs are projected by fiscal year and include manpower, support equipment, facilities, and all other costs associated with indoctrinating recruits into military culture, raising their standards of physical conditioning, and instructing them in basic military skills.

Overall funding for recruit training in FY 2006 was $2.1 billion, down 0.7 percent from FY 2005. The Services anticipate approximately 44,600 more entrants to basic training in FY 2006 than in FY 2005. As the table below shows, the cost of basic training per enlisted Service member will decrease from $12,477 in FY 2005 to $9,764 in FY 2006 and is within 1.2 percent of the targeted $9,646 per enlisted Service member.

Cost of Basic Training (Constant FY 2006 Dollars)					
Metric	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006 Target/Actual[A]
Cost of basic training per enlisted recruit	$8,763	$9,216	$11,734	$12,477	$9,646 / $9,764
[A] FY 2006 data are estimated as of the third quarter.					

Closing Pay Gap

The Department monitors the gap between military pay for enlisted members and pay for comparable civilian positions. To help ensure sufficient military manpower for national defense, the Department tries to maintain competitive salaries and benefits. The Department has found that military pay at about the 70th percentile of pay earned by comparably experienced civilian workers is an effective benchmark for competitive compensation. Military compensation significantly less than the 70th percentile leads to recruiting and retention problems that are costly to remedy. The pay gap for officers was eliminated in FY 2002 through a combination of targeted pay increases, across-the-board raises that exceeded the average increases in the private sector, and general increases in allowances.

Although a good leading indicator of recruiting or retention trends, this metric alone is not sufficient to gauge the overall efficiency or effectiveness of the military personnel compensation program. The Department plans to monitor changes in total military personnel costs, the probability that an enlisted member will remain in service after 15 years, and the average experience at promotion for grades affected by the pay gap.

Measurement of the enlisted pay gap is based on private sector pay by education and years of experience and compared to enlisted pay, by pay grade and years of service. The Department's goal is to close at least 25 percent of the remaining gap annually until the gap is eliminated. After the gap is closed, the goal is to ensure that military pay remains at approximately the 70th percentile of comparable civilians.

As the table below shows, the Department exceeded its target and came very close to eliminating the enlisted pay gap in FY 2006. This positive change was the result of a 3.1 percent across-the-board pay raise compared with a 2.6 percent increase in the private sector, as measured by the Employment Cost Index. Another important factor was a 6 percent increase in the average housing allowance and a 2 percent increase in the subsistence or food allowance.

Military Personnel Costs—Enlisted Pay Gap					
Metric	FY 2002a	FY 2003	FY 2004[A]	FY 2005	FY 2006 Target/Actual
Percentage of enlisted pay gap closed	48%	61%	73%	88%	91% / 97%
[A] Data for FY 2002 and FY 2004 changed from prior reports because the baseline for civilian wages was updated due to the availability of more recent data. FY 2000 costs were used as a baseline.					

Medical Costs

Another metric looks at how well the Military Health System manages the care for those individuals who have chosen to enroll in a health maintenance organization-type of benefit. It is designed to capture: (1) how efficiently a Military Treatment Facility provides care; (2) how efficiently the facility manages the demand of its enrollees; and (3) how well the facility determines whether care should occur inside the facility or be purchased from a managed care support contractor.

The overall measure can be broken into multiple components that allow for review of utilization factors and unit cost information for both direct care and purchased care. Military Treatment Facilities determine how much it costs to provide care and how many times enrollees receive care. The top-level measure is used to track overall performance and the detailed measures allow for review and management at the local level.

The initial data, as shown in the table below, appear to indicate an increase in monthly care costs per enrollee of approximately 7.2 percent compared to the target of 3.8 percent. The Department expects to move closer to its target as more of the claims are completed.

Medical Cost Per Equivalent Life Per Month					
Metric	FY 2002	FY 2003	FY 2004	FY 2005 Target/Actual[A]	FY 2006 Target[B]/Actual[C]
Medical cost per enrollee per month	$168	$179	$192	$213 / $208	$221 / $223
Percentage change	Not available (first year data reported)	6.5%	7.3%	≤10.9% / 8.3%	≤3.8% / 7.2%

Metric information has been updated to reflect change from straight enrollee count to an equivalent life factor. This factor allows for better comparison across time due to changes in enrollees.
[A] FY 2005 data represent the best estimate of final information.
[B] FY 2006 dollar value target is based on a 6-month period for FY 2006 compared to the same period for FY 2005. Dollar values will change as claims data become final.
[C] FY 2006 data are estimated as of the second quarter.

Performance Goal 1.4: Shape the Force of the Future

This goal focuses on developing a military force trained and prepared to meet future threats and international challenges. Metrics are designed to gauge civilian and military human resource strategic planning and the correct "mix" of forces to ensure the appropriate balance between Active and Reserve forces.

Human Resources Strategic Plans

Good human capital management is one of the key tenets of the Department's transformation initiative.

Military Human Resources Strategic Plan

The Department's Military Human Resources Strategic Plan focuses on six goals:
- Increase the willingness of the American public to recommend military service to youth
- Recruit the right number of quality people
- Develop, sustain, and retain the force
- Transition members to and from Active and Reserve status seamlessly
- Develop a flexible, integrated human resources management information system
- Sustain continuous human resources process improvement

This plan establishes the legislative and policy priorities for the next several years, such as the following:

- Accessing enlisted personnel with the right level of education and aptitude
- Ensuring that the force is manned with the right number of military members with the appropriate skills
- Implementing a demonstration program evaluating various personnel management policies and programs for extending careers, such as an "up-and-stay" policy (versus "up-or-out") for certain high-investment specialties

During FY 2006, the Department completed studies that provided: (1) the final report for variable officer career lengths; (2) the Defense Advisory Committee on Military Compensation report for recommendations on a flexible and competitive compensation system; (3) alternatives for the military retirement system and obstacles to their implementation; (4) the report on the Service General and Flag Officer career management process; (5) a validation of the Armed Services Vocational Aptitude Battery; (6) a first step in implementing the policy change to align enlisted grade and experience pyramids; (7) a strategic approach to joint personnel issues; and (8) alternatives for a flexible and competitive compensation system.

Civilian Human Capital Strategic Plan

The Department employs approximately 720,000 civilians worldwide to support its military forces in a wide variety of administrative, technical, and professional occupations.

The Department's Civilian Human Capital Strategic Plan is a comprehensive plan for ensuring a strong civilian workforce, able to meet the mission challenges of today and the future, and guiding the civilian human resources policies, programs and initiatives. In FY 2006, the Department revised the plan to establish long-term goals with performance metrics that align with: (1) the 2006 Quadrennial Defense Review, (2) the Department's overall human capital strategy, and (3) Office of Personnel Management human capital initiatives. The plan is designed to create:

- World Class Enterprise Leaders, who manage people effectively in a joint environment, ensure continuity of leadership, and sustain a learning environment that drives continuous improvement across the enterprise
- Mission-Ready Workforce characterized by agility, flexibility, diversity, and seamless integration with the Total Force
- Results-Oriented Performance Culture that is mission-focused and results-oriented
- Enterprise Human Resources Support that is strategically aligned and customer-focused, and provides measurable, leading-edge results

During FY 2006, the Department focused on implementing the plan and metrics to measure performance. Results will be measured using the evaluation method outlined in the Civilian Human Capital Accountability System, scheduled for completion in the fourth quarter of FY 2006. Annually, the Department will provide a Human Capital Accountability Report to the Office of Personnel Management.

Efficient Civilian Hiring

In 2004, the Office of Personnel Management imposed new goals for both non-Senior Executive Service and Senior Executive Service hiring actions. Non-Senior Executive Service positions should be filled in 45 working days or

less, measured from the date the vacancy announcement closed to the date of the job offer. Senior Executive Service positions should be filled in 30 working days or less, measured from the date the vacancy announcement closed to the date the package was submitted to the Office of Personnel Management Qualifications Review Board. The Department adopted both of these models as its principal measures of hiring efficiency.

Data collection began in FY 2005. The data were benchmarked, data collection processes were refined, and results were verified. The Department began reporting accurate and reliable data during the second quarter of FY 2006.

Job offers for all non-Senior Executive Service positions were made well within the 45-day model. Against the 30-day model for Senior Executive Service positions, the Department reduced its time to an average of 75 days, a 40 percent reduction from the original FY 2005 benchmark of 125 days.

The Department's performance against the models is presented in the table below.

Civilian Recruiting Cycle Time					
End-State Metric	FY 2002	FY 2003	FY 2004	FY 2005 Target/Actual	FY 2006 Target/Actual[A]
Trend data to monitor the number of days appropriated fund positions are vacant	No historical data; new metric	Drafted performance measures Established benchmark with *Fortune 500*	Issued reporting requirements for measure Integrated Office of Personnel Management reporting requirements into the Department's reporting requirements	Collected and validated data Began to characterize results Calculated the Department's time-to-fill metric: 71% actions within 90 days 12% actions within 120 days 17% actions over 120 days Data for Office of Personnel Management metric not yet collected	Non-Senior Executive Service hires: 45 days / 31 days Senior Executive Service hires: 30 days / 75 days

[A] FY 2006 data are final as of the third quarter.

Balance Between Active and Reserve Components

The 2001 Quadrennial Defense Review directed a comprehensive study of the proper mix of the Active and Reserve Component forces. Subsequently, the Secretary of Defense directed the Services to review their force structures and, where required, rebalance them to ease the stress on the Guard and Reserve. The Secretary's guidance was to promote judicious and prudent use of the Reserve Components with force rebalancing initiatives, reduce strain through the efficient application of manpower and technological solutions, and improve the balance of Active and Reserve Component capabilities.

The Department began tracking rebalancing actions in FY 2003. The Services reviewed their force structure initiatives and took rebalancing actions as necessary. The tables below show the results of the Department's efforts to rebalance the Active and Reserve Components. The first table shows the rebalancing results through the end of FY 2006 and the second table shows the projected rebalancing actions between FY 2007 and FY 2012.

Active Component/Reserve Component Force Mix Rebalancing Actions FY 2003 – FY 2006					
Service	Unit of Measure	FY 2003	FY 2004	FY 2005	FY 2006
Army	Spaces	2,500	4,467	16,799	15,365
Navy	Spaces	19,713	8,752	4,699	1,178
Marines	Spaces	0	0	6,000	2,123
Air Force	Spaces	273	5,147	1,407	395
TOTAL	Spaces	22,486	18,366	28,905	19,061

Active Component/Reserve Component Force Mix Rebalancing Actions Projected FY 2007 – FY 2012							
Service	Unit of Measure	FY 2007	FY 2008	FY 2009	FY 2010	FY2011	FY 2012
Army	Spaces	19,704	8,569	2,599	1,288	435	1,186
Navy	Spaces	296	238	(94)	68	8	23
Marines	Spaces	180	0	0	0	0	0
Air Force	Spaces	298	1,069	203	228	258	65
TOTAL	Spaces	20,478	9,876	2,708	1,584	701	1,274

Beginning in FY 2006, the Services must report their rebalancing plans and results in terms of the addition of force structure (spaces) to stressed capability areas. Previous reporting focused on unit force structure changes. This shift in focus may result in report numbers different from those expected. Due to these new requirements, the final results of the Services' efforts to rebalance are not yet available.

Continuum of Military Service

A review of the use of Reserve Component forces directed by the 2001 Quadrennial Defense Review proposed the concept of "continuum of service." Under this concept, a Reservist who normally trains 38 days per year could volunteer to move to full-time service for a period of time or to some increased level of service between full-time and his or her normal Reserve Component commitment, without completely abandoning civilian life. Similarly, an Active Duty Service member could request transfer into the Reserve Component for a period of time, or some status in between, without jeopardizing his or her full-time career and opportunity for promotion. Military retirees with hard-to-find skills could return on a flexible basis and create opportunities to serve for others with specialized skills.

This concept allows for better transition between Active and Reserve Component service and enhances Reserve Component usage. Some initiatives related to the continuum concept will require legislative, policy, or regulatory changes that may take several years to complete. Currently, the Department's efforts are focused on: (1) creating a seamless flow between Active and Reserve Component forces; (2) encouraging volunteerism and establishing new

affiliation programs; (3) simplifying rules for accessing, employing, and separating Reserve Component personnel; (4) increasing the flexibility of the Reserve Component compensation system; and (5) enhancing combined Active and Reserve Component career development.

Strategic Goal 2:
Balance Operational Risk - Achieve and Maintain Operational Superiority

This goal focuses on the Department's efforts to create plans that can be adapted quickly as events unfold, train for the next real-time mission, and supply the warfighters with the resources they need immediately. These challenges are today's threats, so goals address achieving near-term objectives, not long-term outcomes.

Performance Goal 2.1:
Maintain Force Readiness

In today's rapidly changing world, the Department must have the capability to respond quickly and effectively to a wide range of potential challenges. The Department is replacing existing planning methods that are too deliberate and slow with a new system that will yield plans that provide relevant options to the President and Secretary of Defense on a timely basis. The long-term goal is to have a networked capability to produce, update, and transition through crisis situations seamlessly by the end of FY 2009. The Department refers to this capability as "net-centricity," which means harnessing the power of information connectivity by enabling critical relationships between people and organizations.

Adaptive Planning

Adaptive planning is a methodology for developing timely war and contingency plans responsive to the current security environment. The Department plans to have the initial spiral of capability to produce plans on demand by 2008 via the DoD's Secret Internet Protocol Network (SIPRNET) together with web portal and tools to obtain process and display data from the military services and agencies.

In FY 2006, the Secretary approved a three-phased approach to the adaptive planning:

- Phase I—Initiation (through FY 2007), which will deploy new technology and exercise portions of the adaptive planning construct on select priority plans.
- Phase II—Implementation (FYs 2007–2008), which will produce electronic plans for all contingencies in a collaborative joint command and control environment.
- Phase III—Integration (FY 2009 and beyond), which will produce and maintain "living" plans in a collaborative environment.

The Department continues to test and refine the web-based tools used to build campaign plans. Additional tools, such as war-gaming, are being integrated into the web portal or are under consideration. These tools will be interoperable with authoritative data sources and key command and control planning and execution systems.

Analytic Baselines

The Secretary of Defense directed that the Department create a foundation, or set of analytic baselines, for strategic analyses that rely on common scenarios and data. These baselines are intended to help provide responsive and analytically sound insights to help senior staff make decisions on joint warfighting issues and policy. The analytic baselines provided a "warm starting point" for Quadrennial Defense Review analytic efforts and insights. The Department continues to develop and update its analytic baselines.

Operational Lessons Learned

The Department takes lessons learned very seriously and ensures that lessons learned are integrated into training processes and systems. Lessons learned from operational missions must be captured systematically and injected into the full range of preparatory and planning activities; ongoing experimentation; concept development; doctrine; and joint tactics, techniques, and procedures development. These actions will result in a robust Joint Lessons Learned Program that encompasses the range of joint Military Service, Reserve, and Guard Component activities. The Department developed the strategic and operational requirements for a collaborative, web-enabled, and net-centric Joint Lessons Learned Information System. This system, when fully operational, will facilitate knowledge management of lessons learned in concert with the Joint Training System, the Joint Training and Information Management System, the Defense Readiness Reporting System, and Military Service systems through the Global Information Grid.

Defense Readiness Reporting System Implementation

The 2001 Quadrennial Defense Review directed the Department to change fundamentally the way force "readiness" is measured, reported, and resolved. The Department launched a series of policy and procedure changes to develop and use a new readiness reporting and assessment system. When implemented, the system will provide capabilities-based, adaptive, near-real-time information for all military units. Readiness will be assessed from the perspective of the Combatant Commanders. This is important because Combatant Commanders describe their roles and responsibilities in terms of mission-essential tasks and assigned missions or core tasks first, and then assess their ability to conduct those tasks.

In June 2006, the Department released a new version of the Defense Readiness Reporting System that integrates mission-essential task assessment functionality with asset visibility in a single software application. The Department also released additional system guidance. This system is being used actively to support various readiness forums in the Department and to answer readiness questions at the highest levels.

Performance Goal 2.2
Ensure Superior Capabilities Exist to Succeed

This goal focuses on the Department's efforts to have the right capabilities in the right place to achieve the desired effect—before deploying forces to deter or fight an adversary. A key part of this goal is to ensure that the Department recognizes how deploying forces from one region to another may impede or enhance its ability to accomplish strategic goals in another region or at home.

Global Force Management

Global Force Management is a method for monitoring joint force operational availability. It is designed to manage continuously the process that provides forces to conduct operational missions (called "sourcing") using analytically-based availability and readiness management methods. The objective is to integrate data on worldwide availability and readiness. This process provides comprehensive insight into U.S. force availability worldwide and accounts for ongoing operations and constantly changing unit availability. It leverages the most responsive, best-positioned force at the time of need and guides the allocation of Service forces that rotate into the theater. The term "theater" refers to a strategic area of national security interest.

Global Force Management also provides senior decision-makers a way to: (1) assess risk in terms of forces available to source Combatant Commanders' war plans, and (2) predict the likely stress on the force associated with proposed allocation, assignment, and apportionment changes. In simple terms, Global Force Management ensures that decision-makers know the location and status of all forces so that they can make informed assignment decisions. In FY 2006, the Department improved its existing force assignment information to develop optimal joint force sourcing solutions. The Department also completed its initial electronic documentation of organizational hierarchies, command and support relationships, and manpower.

Theater Security Cooperation

Theater security cooperation entails developing the right defense partnerships with friends and allies to promote specific U.S. security interests. Recently, the Department initiated a comprehensive security cooperation strategy review that focused the activities of Combatant Commands, the Services, and Defense Agencies on common goals to garner the necessary cooperation. Security cooperation embraces all interactions with foreign defense establishments, and it is the primary means of building relationships that promote specific U.S. security interests. Security cooperation activities help America's allies develop military capabilities for self-defense and to support coalition operations. They also provide information, intelligence, and access. In FY 2006, the Department published and began to implement its Security Cooperation Guidance. The first comprehensive security cooperation assessments were submitted, analyzed, and forwarded to the Secretary of Defense. The Department is researching assessment metrics for determining the effectiveness of the security cooperation program and evaluating the capabilities required for security cooperation.

Performance Goal 2.3:
Align Forces Consistent with Strategic Priorities

This goal focuses on developing plans and concepts to ensure that the Department's forces are able to work together in a wide variety of joint operations in any number of circumstances around the globe.

Joint Concepts

Joint concepts provide the operational context for the transformation of the Armed Forces by bridging the gap between strategic guidance and the Department's strategy for providing resources for operations. As they are revised, all joint concepts are written in a problem/solution format to facilitate validation through assessment and experimentation.

The Capstone Concept for Joint Operations guides the development of future joint capabilities as well as force development and employment, primarily by providing a broad description of how the future joint force will operate across the range of military operations 8 to 20 years in the future. Joint Operating Concepts apply a solution in greater detail to a specified mission area, while Joint Functional Concepts apply elements of the capstone solution to describe how the joint force will perform an enduring military function across the range of military operations. Joint Integrating Concepts provide an operational-level description of how a joint force commander will perform a specific operation or function. In FY 2006, the Department institutionalized joint collaboration; informed strategy, operational plans, and defense planning scenarios; generated a robust body of joint warfighting knowledge; provided a solid conceptual basis for joint experimentation; described cross-cutting military functions; identified key joint force capabilities required, and identified 93 joint capability gaps.

Performance Goal 2.4: Transition Forces Rapidly to Meet New Threats

This goal focuses on strategies to ensure that the Department can respond to threats in a variety of ways by using all of its available resources.

Operational Availability

The Department must prevent terrorists from harming America, its people, and its friends and allies. The Department must be able to rapidly transition military forces to post-hostilities operations, and identify and deter threats to the United States, while standing ready to assist civil authorities with mitigating the consequences of a terrorist attack or other catastrophic event. These diverse requirements demand integration with and leveraging of other elements of national power, such as international alliances and partnerships. The Department is developing a broader portfolio of capabilities and is realigning forces using a building-block approach to match those capability portfolios with mission goals. Continued implementation of several of the Department's initiatives previously discussed, such as Global Force Management, Adaptive Planning, and Analytic Baselines, will help the Department meet this goal.

Strategic Goal 3: Balance Institutional Risk - Improve Organization Efficiency to Support the Warfighter

This goal focuses on the Department's internal transformation efforts to streamline the decision process, improve financial management, build a base of facilities ready and able to meet the highest standards for quality and readiness, and drive acquisition excellence.

Performance Goal 3.1: Improve the Readiness and Quality of Key Facilities

This goal focuses on the physical property assets that support the Department's mission and its people.

Eliminate Inadequate Domestic Family Housing by 2007

The Department's goal is to ensure that Service members and their families are provided safe, modern, and attractive housing that the average American would be proud to call home. Housing can be a key factor in recruitment and retention decisions. The issue is important enough to warrant a stand-alone initiative in the President's Management Agenda. As of September 30, 2006, the Department was rated green on both status and progress.

The Department plans to eliminate all inadequate family housing at bases located in the United States by the end of FY 2007 and at bases located in other countries by FY 2009. In general, inadequate housing is any unit that requires a major repair, component upgrade, component replacement, or total upgrade. Each Service evaluated its housing, identified inadequate units, and developed a plan to eliminate these units through a combination of traditional military construction, operations and maintenance support, and privatization. The plans are updated annually in the President's Budget.

For FY 2006, the Department is on track to exceed its target by eliminating more than 29,000 inadequate housing units. The table below shows the Department's progress in reducing inadequate housing for Service members and their families.

Inadequate Domestic Family Housing (numbers in thousands)

Metric	FY 2002[A]	FY 2003[A]	FY 2004[A]	FY 2005	FY 2006 Target /Actual[B]
Number of inadequate family housing units (U.S.)	130.5	115.6	93.3	61.3	27.6 / 29.2245
Inadequate family housing units as a percentage of total family housing units (U.S.)[C]	59%	59%	55%	50%	40%

[A] Prior-year values changed based on revised family housing inventory data included in the Services' FY 2007 President's Budget requests.
[B] FY 2006 actual data are estimated as of the end of the third quarter.
[C] Percentages decrease gradually because the total owned housing is also decreasing due to privatization.

Fund to a 67-Year Recapitalization Rate

The Department's facilities recapitalization metric measures the rate at which the facilities inventory is being recapitalized. Recapitalization means to restore or modernize facilities. Recapitalization may involve total replacement of individual facilities, but often occurs incrementally over time without a complete replacement. The performance goal for recapitalization equals the average expected service life of the facilities inventory, currently 67 years. That average is based on the expected service life benchmarks, weighted by value of the facilities represented by each benchmark.

The FY 2006 recapitalization rate estimated at 73 years exceeds the budgeted rate of 111 years, an outcome similar to that of FY 2005 in which the actual rate of 67 years exceeded the budgeted rate of 104 years. The increased

investment in recapitalization is influenced by two factors: (1) supplemental funding to restore facilities damaged or destroyed by Hurricanes Katrina and Rita, and (2) the initiation of FY 2005 Base Realignment and Closure spending.

The expected service life of the facilities inventory is also a function of facilities sustainment. Sustainment includes the routine maintenance and repair necessary to achieve the expected service life. To achieve a normal expected service life, full sustainment levels must be assumed. A reduced expected service life results from less than full sustainment. Sustainment levels required to achieve a normal expected service life are benchmarked to commercial per-unit costs; for example, $1.94 per square foot is needed annually to properly sustain the aircraft maintenance hangar inventory over a 50-year life cycle. The facilities sustainment model adjusts these costs to local areas. The Department's goal continues to be full sustainment annually for all facilities. Fully sustaining the Department's facilities is more cost effective over the life of the facility and prevents the premature deterioration that leads to more costly restoration requirements.

In the future, the title of this metric will be changed to more accurately reflect its content. The metric appropriately addresses facilities sustainment as well as recapitalization. Since both are addressed, the title of this metric beginning with FY 2007 will be "Real Property Asset Life-Cycle Metrics."

Status of Funding a 67-Year Recapitalization Rate

Metrics	FY 2002	FY 2003	FY 2004[A]	FY 2005[B]	FY 2006
Facilities recapitalization metric (years)	101	149[C]	88[D]	67[E]	73
Facilities sustainment model (percent)	89%[B]	93%	71%	79%	91%

FY 2006 data are estimated as of the year-end.
[A] Three Defense Agencies (Defense Logistics Agency, the Department of Defense Education Activity, and TRICARE Medical Activity) were included beginning in FY 2004, but excluded in previous years.
[B] Estimated (the Facilities Sustainment Model was first fielded in FY 2003)
[C] FY 2003 data are as of the FY 2005 President's Budget.
[D] FY 2004 data are as of the FY 2006 President's Budget.
[E] FY 2005 data are as of the FY 2007 President's Budget..

Performance Goal 3.2: Manage Overhead and Indirect Costs

This goal focuses on the Department's efforts to control its overhead costs and maximize the funds available for direct support to the warfighter.

Reduce Percentage of the Department Budget Spent on Infrastructure

The budget share devoted to infrastructure is one of the principal measures used by the Department to gauge progress toward achieving its infrastructure reduction goals. A downward trend in this metric indicates that the balance is shifting toward less infrastructure and more mission programs. The Department updates the percentage

of the budget spent on infrastructure each time the President's Budget is revised. The Institute for Defense Analyses reviews and normalizes the data to adjust for the effect of definitional changes in the database that mask true content changes. Prior-year data are normalized to permit accurate comparisons with current-year data. Because of these adjustments, there may be slight shifts upward or downward in the targets established for past-year infrastructure expenditures.

The Department will allocate an estimated 42 percent of total obligational authority to infrastructure activities in FY 2006, about the same as the preceding year. The Department continues to maintain its allocation of resources to forces fighting the Global War on Terror and meeting other operational requirements. The percentage of infrastructure requirements has decreased slightly since FY 2002 due to reform initiatives, including savings from previous Base Realignment and Closure rounds, strategic and competitive sourcing initiatives, and privatization and reengineering efforts.

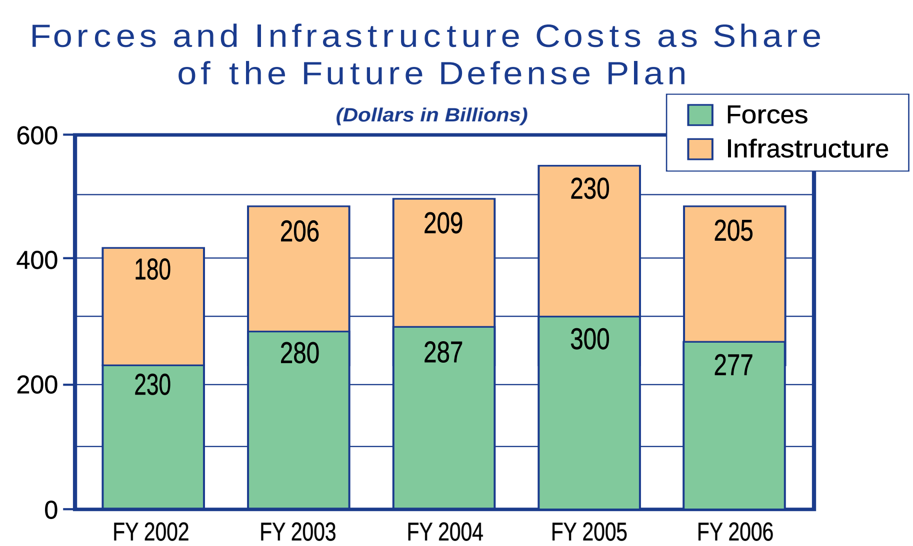
The tables below show the percentage and dollar amounts the Department has spent on infrastructure.

Defense Budget Spent on Infrastructure

Metric	FY 2002	FY 2003	FY 2004	FY 2005 Target/Actual	FY 2006 Target/Actual[A]
Department budget spent on infrastructure (percent)	44%	42%	42%	42% / 43%	42% / 42%

[A] FY 2006 data are estimated as of the fourth quarter. This is a lagging indicator. Projections are based on the FY 2007 President's Budget and the Future Years Defense Program.

The following chart shows the dollars spent on infrastructure consistent with the percentages provided in the previous table.



Performance Goal 3.3: Realign Support to the Warfighter

This goal focuses on the Department's efforts to shift support to the warfighter by providing equipment and supplies more quickly and by minimizing costs associated with the acquisition process.

Reduce Customer Wait Time

Customer wait time measures the elapsed time from when a customer orders and receives an item. The customer's order may be filled from assets on hand at the customer's military installation or naval vessel, or through the Department's wholesale logistics system. This metric includes orders for spare and repair parts ordered by organizational maintenance activities. Below the enterprise level, customer wait time is captured by each of the Military Services and the Defense Logistics Agency.

The table below shows that, through the second quarter of FY 2006, the Department experienced an average customer wait time of 17 days. The Department has reduced its wait time over the past several years but did not meet the FY 2006 target of 15 days due to the continuously high demand for critical items, primarily due to the Global War on Terror, and to delays in closing out transactions. The Department continues efforts to reduce customer wait time through supply chain improvements.

Customer Wait Time					
Metric	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006 Target/Actual[A]
Customer wait time (in days)	16	19	23	21	15 / 17
[A] FY 2006 data are final as of the second quarter.					

Acquisition Reform

The Department uses three metrics to track efforts to reduce costs and improve the speed in which the Department completes major acquisitions.

Reduce Major Defense Acquisition Program Annual Rate of Acquisition Cost Growth

The Department measures the amount that acquisition costs grow from year to year. Acquisition cost growth can occur for various reasons, including technical risk, schedule slippage, programmatic changes, and overly optimistic cost estimates. The Department seeks to reduce cost growth from all sources, providing an output target for procurement managers of individual systems, as well as for the aggregate procurement programs of the individual Services. The objective is a downward trend toward an ultimate goal of no growth.

The table on the next page shows the trend in the annual growth in acquisition costs.

Major Defense Acquisition Program Annual Rate of Acquisition Cost Growth (Lagged)						
Metric	FY 2001[A]	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006 Target/Actual[B]
Percent annual growth	13.9%	6.4%	5.0%	3.5%	6.9%	Data Not Available

Acquisition cost growth is calculated using data from the December Selected Acquisition Reports.
[A] Results for FY 2001 reflect acquisition cost growth for a 2-year period (FYs 2000 and 2001). There were no December 2000 Selected Acquisition Reports, because a Future Years Defense Program was not included in the FY 2002 President's Budget submission.
[B] Results for FY 2006 will be available in April 2007 with the release of the December 2006 Selected Acquisition Reports.

Reduce Major Defense Acquisition Program Acquisition Cycle Time

Leveraging new technologies faster through rapid development and fielding of weapon systems will enable U.S. forces to stay ahead of the equipment advances of potential adversaries. Acquisition cycle time is the elapsed time from program initiation—when the Department makes a commitment to develop and produce a weapon system—until the system attains initial operational capability. The Department measures the average cycle time across all Major Defense Acquisition Programs.

During the 1960s, a typical acquisition took 84 months to complete. By 1996, a similar acquisition required 132 months from program start to initial operational capability. To reverse this trend, the Department established an objective to reduce the average acquisition cycle time for Major Defense Acquisition Programs started since 1992 to fewer than 99 months, a reduction of 25 percent. The Department achieved that initial objective by using techniques such as demonstrated technology, time-phased requirements and evolutionary development, and integrated test and evaluation.

The Department is seeking to reduce the average cycle time to fewer than 66 months for all Major Defense Acquisition Programs started after FY 2001. The table below shows that the Department has not met its target. To achieve the objective, the Department is introducing further improvements to development and production schedules similar to those initiated for managing system performance and cost.

Major Defense Acquisition Program Acquisition Cycle Times (in months)						
Metric	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005 Target/Actual	FY 2006 Target[A]
Acquisition cycle time for new starts in FY 1992–FY 2001	102	103	102	101	<99 / 101	<99 / Not Available
Acquisition cycle time for new starts after FY 2001	N/A	N/A	76	80	<66 / 81	<66 / Not Available

[A] Results for FY 2006 will not be available until the April 2007 release of the December 2006 Selected Acquisition Reports.

Reduce Major Defense Acquisition Program Operating and Support Cost Growth

This metric measures the amount that operating and support costs grow from year to year. Operating and support costs are the infrastructure expenses associated with acquisition programs. Real cost growth can occur for various reasons, including technical or programmatic changes, changes in the support strategy or concept, and overly optimistic cost estimates. The Department's objective is to attain a zero percent operating and support cost growth. The table below only shows results for 2 years, which is not enough data to provide meaningful trend analysis. Over time, this metric will help the Department manage its costs.

Major Defense Acquisition Program Operating and Support Cost Growth						
Metric	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006 Target/Actual[A]
Percentage of annual operating and support cost growth	No historical data; new metric	No historical data; new metric	Established metric baseline from which to measure growth	2.3%	6.0%	0% / Not available
[A] Results for FY 2006 will be available in April 2007 with the release of the December 2006 Selected Acquisition Reports.						

Performance Goal 3.4: Streamline the Decision Process, Improve Financial Management, and Drive Acquisition Excellence

This goal focuses on improving the Department's planning structure to ensure that decisions are based upon an accurate baseline of facts and information.

Improve the Transparency of Component Budget Submissions for Alignment of Program Review to Strategic Trades

Improving the transparency of the Department's Component program and budget submissions will help align resource plans and enable senior-level decision-makers to reach better-informed decisions for strategic resource trades.

To achieve a consistent baseline, the Department must first streamline the flow of data. Each data element should be collected once by a single authoritative source collection system, and all parties should agree on the accuracy and validity of the data, as well as the authority of the source that provided it. The Department can reuse the same resource data with confidence to support multiple decisions.

Efforts to refine the submission of program and budget data are underway in the Services, Defense Agencies, and the Office of the Comptroller. Streamlining the data flow to eliminate dual submissions between budget and program systems and standardizing and reducing requirements will reduce workload and improve data quality. Criteria that measure transparency improvements include: (1) the number of data elements requested at each point in the cycle, and (2) the level of human effort required annually to maintain data structure accuracy.

The Department's Enterprise Transition Plan includes a target to fully deploy the systems supporting this metric by FY 2010. As part of this plan, a unified information architecture will be implemented by FY 2008.

Increase Visibility of Trade Space

"Trade space" is the range of budget alternatives available to the decision-maker, based on full knowledge of real and potential impacts. In FY 2003, the Department restructured its budget planning guidance to better define where more or less risk should be taken across the Department's programs. This revised structure directed the Services and Agencies to apply explicit criteria for risk management and to align their resource plans accordingly. During the program and budget review, any resource proposal that varied from guidance was corrected in the President's Budget.

The Department further strengthened the guidance as a resource decision tool by adding more details on how Services and Defense Agencies were expected to meet the Secretary's intent within fiscal constraints. The Strategic Planning Guidance, issued in FY 2006, marked the first attempt to estimate the direct cost of program priorities within the context of the overall Department's budget. It is still difficult to develop a truly independent cost estimate of planning priorities or to assess accurately all the variables associated with estimating the potential trade space created by accepting increased risk in some areas of the Department.

The newly initiated Enhanced Planning Process will provide a continuous, open, and collaborative analytic forum to examine closely issues of the greatest interest to the Secretary. The process is intended to produce programmatic recommendations that will be documented in a new annual publication, the Joint Programming Guidance.

Provide Explicit Guidance for Program and Budget Development

In March 2003, a study team explored ways to make the existing program and budget development process less cumbersome, more responsive, and more helpful to the Secretary in managing and enhancing joint capabilities. The Joint Defense Capabilities Study, completed in November 2003, recommended focusing the Secretary's annual planning and programming guidance on high-level strategic issues, and framing resource alternatives as capabilities rather than programs. The study also recommended that actual results become a formal part of the overall assessment process. Accordingly, "execution of funds" was added to the overall process, and became the Department's Planning, Programming, Budgeting, and Execution System. The Department has enhanced its planning process to focus on strategic and joint issues that address core military capabilities.

To implement the 2006 Quadrennial Defense Review Report, the Department developed eight execution road maps:
- Institutional Reform and Governance
- Strategic Communications
- Building Partnership Capacity
- Sensor-Based Management of the Intelligence, Surveillance, and Reconnaissance Enterprise
- Authorities
- Irregular Warfare
- Joint Command and Control
- Tag, Track, and Locate

In developing the road maps, the Department conducted experiments and studies to evaluate proposals for improving its planning, programming, and budgeting decision processes. In addition, the Department continued to modify its decision-making processes to strengthen the linkages between planning, budgeting, and execution. To monitor these activities, the Department established a Quadrennial Defense Review Execution Office, which reports progress to the Secretary.

Strategic Goal 4:
Balancing Future Challenges Risks - Execute Future Missions Successfully Against an Array of Prospective Challengers

This goal focuses on the Department's efforts to transform over time to effectively counter the increasing rate of change and degree of uncertainty in the regional and global threats faced by the United States.

Performance Goal 4.1:
Define and Develop Transformational Capabilities

This goal focuses on the Department's efforts to take into account not just the challenges to immediate war plans, but also the challenges to people and transformation. The Department has moved from a "threat-based" to a "capabilities-based" approach to defense planning, focusing not only who might threaten America, or where, or when—but more on how the U.S. might be threatened, and what portfolio of capabilities the Department will need to deter and defend against those new threats.

Transformation is not only about technology. It is also:

- Changing the way challenges and opportunities are viewed
- Adapting the Department to that new perspective
- Refocusing capabilities to meet future challenges instead of those the Department is currently prepared to meet

Intelligence Activities

The Department focuses on explicit and effective measures for its intelligence activities to deny our enemies advantages while exploiting their weaknesses by employing intelligence, security, and counterintelligence means. The success of any intelligence program depends on four fundamental areas:

- Aligning intelligence, security, counterintelligence strategy, policy, and processes for maximum effectiveness and efficiency
- Integrating intelligence activities horizontally (i.e., communication among and within agencies to promote information sharing)
- Focusing intelligence activities on supporting the warfighter's requirements
- Improving intelligence, surveillance, and reconnaissance capabilities

The Department's intelligence community is conducting numerous activities to improve the effectiveness of intelligence in military operations and for overall national security. Further, the Department requires current and comprehensive policies to guide its intelligence community in accordance with the four fundamental areas. The ongoing efforts include identifying directives, instructions, regulations, and manuals that should be developed, modified, or canceled.

One of the major developments to come out of these activities is the Intelligence Campaign Planning process to integrate, synchronize, prioritize, and focus the Department's intelligence on achieving specific military objectives. In simple terms, this process determines what information is needed, identifies knowledge gaps and capability shortcomings, and coordinates with the broader intelligence community to mitigate the shortfalls.

The Department is conducting a definitive review of all existing policies and directives relating to intelligence, counterintelligence, and security activities to codify a common language and understanding of intelligence issues. Various targeted activities address intelligence shortcomings for each of the four fundamental areas.

In FY 2006, the Department's intelligence community took steps to increase its role in sharing terrorist screening information with intelligence and law enforcement communities directly supporting the Global War on Terror. It worked across the Department and the broader intelligence community to resolve many impediments related to sharing intelligence information about foreign disclosure and coalition operations. This effort resulted in significantly improved intelligence access for Combatant Commands.

Technology Innovation

Global Net Enabled Information Sharing Environment

Today's diverse mission environments require the secure, quick, and accurate movement of information in support of military operations and Combatant Commanders. The Department's ability to construct a global information network configured with the information required for modern combat operations and able to support critical command and control requirements has been limited by the flow of information through the network and processing power at any given time or point.

The foundation of a Net Enabled Information Sharing Environment is commercially available information technology with enhancements that will:

- Achieve a ubiquitous, assured, and robust multi-security level Internet Protocol based information transport networks;
- Provide bandwidth and computing resources matched to user's missions needs;
- Provide collaboration tools and other mission support tools: and,
- Assure authorized access by managing the identity of users whether human or software

The Department is continuing with information technology enhancements to establish specific geographic requirements and meet the demands of the Global War on Terror. In FY 2006, the Department made significant progress in developing communications paths and infrastructure upgrades to support ongoing operations around the world.

The Department increased investments in information transport and development of better bandwidth requirements utilization models that will allow greater capacity needed to support warfighter needs. In addition, the Department restructured its future satellite communications approach to ensure both the successful and timely delivery of increased capability and the synchronization of the phasing and pacing of terminals and space vehicles.

The Department began a pilot implementation of Internet Protocol version 6 (IPv6) on intranets that carry operations traffic. The Internet Protocol provides the addressing mechanism that defines how and where information such as text, voice, music, and video move across seperately owned and operated networks. The current Internet protocol cannot accommodate the increasing number of global users and devices that are connecting to the Internet. As a result, IPv6 was developed to overcome those limitations by expanding available address space, improving end-to-end security, facilitating mobile communications, enhancing quality of service, and easing system management burdens. All federal agencies, including the Department, are transitioning to IPv6.

The Department instituted an aggressive multi-level network and has increased priority and funding for information assurance to build a robust combination of network defenses to meet today's cyber-threats. In addition, the Department initiated a significant research and development effort focused on defense and protection tools for information systems. The Department is also continuing efforts to reduce software assurance risk and is developing a software assurance strategy for use on major acquisition programs.

Defense Technology Objectives

Technological superiority is a cornerstone of military strategy. Technologies such as radar, jet engines, nuclear weapons, night vision, smart weapons, stealth, the Global Positioning System, and vastly more capable information management systems have changed warfare dramatically. Today's technological edge allows the Department to prevail decisively across a broad spectrum of conflicts and with relatively few casualties. Maintaining this technological edge has become even more important as the size of U.S. forces decreases and high-technology weapons are now readily available on the world market. Future warfighting capabilities will be determined substantially by today's investment in science and technology.

Science and technology investments are focused and guided through a series of Defense Technology Objectives developed by senior Department planners. Each objective highlights a specific technological advancement, the anticipated date the technology will be available, the specific benefits that should result from the technological advance, and the funding required (and funding sources) to achieve the new capability. These objectives specify milestones and approaches, quantitative metrics that will indicate progress, and the customers who will benefit when the new technology is fielded. This metric measures the percentage of Defense Technology Objectives that are progressing satisfactorily toward the established goals. In accordance with the Department's new review process that evaluates all objectives biennially, the FY 2006 assessments are in process. The table on the next page shows the results through the third quarter, FY 2006.

Status of Defense Technology Objectives					
Metric	FY 2002	FY 2003	FY 2004	FY 2005 Target/Actual[A]	FY 2006 Target/Actual[A,B]
Percentage of Defense Technology Objectives evaluated as progressing satisfactorily toward goals	97%	96%	94%	0	≥70% / 99%
Objectives evaluated in biannual review[C]	149[C]	163[C]	180	0	88
Total number of objectives[C,D]	401	386	404	392	404

[A] The Department implemented a new comprehensive review process that evaluates all objectives biennially. The latest review and assessment of Defense Technology Objectives was conducted in FY 2006 (not all FY 2006 results have been reported).
[B] FY 2006 data are as of the third quarter.
[C] No targets are established for the objectives evaluated or total number of objectives.
[D] The total number of objectives is the sum of all objectives contained in the Joint Warfighting Science and Technology Plan and the Defense Technology Area Plan, dated February of the calendar year prior to the fiscal year in which the reviews are conducted.

Net-centric Solutions

Military commanders need and use information of all kinds, not just intelligence data, to "see" the battle space and defeat adversaries. Data must be visible, available, and understandable when and where needed to accelerate decision-making. The net-centric enterprise architecture will enable commanders to engage the network at anytime from anywhere using a military version of the Internet search engine, without needing cumbersome base support. Data will be posted and ready for download and analysis as soon as they arrive, anywhere on the network. As an example, during recent operations in Afghanistan and Iraq, ground forces could reach remote Unmanned Aerial Vehicle pilots in Nevada to direct the vehicles in support of local operations in real time.

The Department's net-centric solution will be completed no later than FY 2008, by which point all of the Department's data will comply with standards to be accessible, discoverable, and usable. The Department is moving forward with a broad data strategy based on development of a common data structure and strengthening of standards, organizations, and categorization schemes. These changes allow for improved information sharing and information assurance across a multitude of domains from personnel to intelligence information systems. The data strategy is being implemented by developing and revising requirements, acquisition, and budgeting processes. The Department also is developing a strategy focused on information sharing with federal, state, local, and coalition partners.

Performance Goal 4.2: Define Skills and Competencies for the Future

This goal focuses on the Department's efforts to prepare for the future. History has shown that rapid and unexpected change can transform the geopolitical landscape. New technologies can revolutionize the character of armed conflicts in ways that render previous doctrine and capabilities obsolete.

Intelligence Human Resources System

To accomplish its mission, the Department's intelligence components must have the best people available. The components need to recruit agile problem-solvers with broad and varied experiences who can operate in an environment which changes as the threat changes. A key first step is the development of the Defense Civilian Intelligence Personnel System, a common human resources system for the Department's intelligence components. When fully implemented, this system will provide a competitive, performance-driven compensation structure and significantly enhanced hiring flexibilities. In addition, increased value is placed on personnel with critical foreign language skills (native and heritage speakers) who play an especially important role in the collection of intelligence. The Department established standards for training, tradecraft, technology, architecture and operational tactics, techniques, and procedures across the Department to ensure all elements are working together to meet the needs of Combatant Commands, Military Departments, and senior-level decision-makers.

Strategic Transformation Appraisal

The Department's overall transformation roadmaps address activities, processes, resources, and incentives to foster and promote innovation and transformation activities, including concept-based experimentation processes, education and training programs, and the use of operational prototypes. Each Service and Defense Agency prepares an annual update of information and a roadmap on its transformation efforts. The roadmaps represent a shared future vision and complement the program and budget process, ensuring coherence between resource allocation decisions and future concept development and experimentation. Roadmaps also provide a baseline for managing transformational change within the force and articulate strategies for implementing and managing transformation risks.

Each year, the Department evaluates the progress and plans in the individual and joint transformation roadmaps, and assesses the gaps or adjustments requiring action. The Strategic Transformation Appraisal is the Department's only strategic-level risk assessment management tool. The transformation information packages from the Services were complete or nearly complete as of the end of July 2006. The package from the Defense Agencies is complete. The Department expects to complete the Strategic Transformation Appraisal of these packages by December 31, 2006.

Performance Goal 4.3: Develop More Effective Organizations

This goal focuses on the Department's efforts to structure, train, deploy, and manage joint forces and organizations. Transformation efforts are aimed at enabling joint operations that combine land, sea, air, and space forces, under the control of a single Combatant Commander, to use in ways that are most appropriate to achieving a specific objective. Successful cultural change requires not only wanting to fight jointly, but to think jointly.

Homeland Defense

The Department's highest priority is protecting the U.S. homeland from attack through the full range of activities associated with an active homeland defense, including military missions in the forward regions, approaches to

the U.S., the U.S. homeland, and global commons (i.e., international waters and airspace, space, cyberspace). Specifically, the Department must be able to:

- Conduct military missions to prevent, deter, defend, and defeat attacks on the U. S., the U.S. population, and defense critical infrastructure
- Support civil authorities directed by the President or Secretary of Defense as part of a comprehensive national response to prevent and protect against terrorist incidents or manage the consequences of attack or disaster
- Enhance contributions of domestic and foreign partners to homeland security and homeland defense

To meet the challenges of the post-9/11 threat environment, the Department developed a comprehensive strategy for homeland defense and civil support. This new strategy relies on an integrated threat assessment to define the Department's strategic goals, key objectives, and core capabilities for homeland defense and civil support. The strategy will describe associated force structure, technology, and resource implications. By aligning strategic goals with resource and technology plans, the Department will add coherence and direction to the disparate activities to deter and prevent attacks, protect critical defense and designated civilian infrastructure, provide situational understanding, and prepare for and respond to incidents.

The strategy for homeland defense and civil support was incorporated into the 2006 Quadrennial Defense Review. It addressed how the Department will: (1) protect defense-critical infrastructure, (2) provide for force protection; (3) maintain mission-essential functions and services; (4) communicate to federal, state, local, and international partners; and (5) support the federal effort to prepare for, prevent, and, if necessary, respond to the pandemic influenza and natural disasters.

Establish a Standing Joint Force Headquarters

In 2003, the Secretary of Defense directed Combatant Commanders to establish a Standing Joint Force Headquarters with a 58-person core team that serves as a planning staff during day-to-day operations. In the event of a crisis, a headquarters team—with the command structure and staff as well as functional and geographic expertise—is already in place for rapid reaction. The headquarters is prepared immediately to execute command and control functions for the integrated employment of air, land, sea, and information forces. The headquarters is made up of joint-trained personnel skilled in using computer-based analysis tools and joint information and processes. To operate in the field, each deployable headquarters must have a deployable joint command and control capability. All Combatant Commanders have recently established their headquarters.

Transform the Department's Training

Training Transformation is designed to provide dynamic, capabilities-based training in support of national security requirements across the full spectrum of the Department's operations. One of the leading indicators is the percentage of critical Combatant Command billets manned by Joint Specialty Officers. A higher percentage indicates increased performance in jobs that require knowledge of joint matters, such as Critical Joint Duty Assignments. To become a Joint Specialty Officer, an officer must successfully complete an appropriate program of Joint Professional Military Education, followed by a Joint Duty Assignment. These assignments are 2- to 3-year

positions in a multi-Service or multi-national Command or activity involved in the integrated employment or support of the land, sea, and air forces of at least two of the three Military Departments. The Department tracks critical positions filled by Joint Specialty Officers.

The table below shows that only 68.8 percent of military officers filling critical positions were certified Joint Specialty Officers (or the certification requirement was waived by the Chairman of the Joint Chiefs of Staff). This was due to overall manpower shortfalls and conflicting operational priorities for the Global War on Terror. In response, the Department developed a strategic plan that will be the basis for proposed legislative and policy changes to update joint officer management for current needs of the Department.

Joint Specialty Officers in Combatant Commander Critical Positions					
Metric	FY 2002	FY 2003	FY 2004	FY 2005 Target/Actual	FY 2006 Target/Actual
Percentage of military officers in Combatant Commander critical positions certified as Joint Specialty Officers (or waived by the Chairman of the Joint Chiefs of Staff)	No historical data; new metric	No historical data; new metric	No historical data; new metric	90% / 68%	90% / 68.8%

Performance Goal 4.4: Drive Innovative Joint Operations

This goal focuses on efforts to facilitate joint operations. Successful transformation requires fashioning joint concepts to guide the conduct of joint operations. The Department identified eight key operational capabilities where joint operations are critical for deterring conflict and conducting military operations:

- Strengthen intelligence
- Protect critical bases of operation
- Operate from the global commons
- Protect and sustain forces in remote locations
- Deny enemies sanctuary
- Conduct network-centric operations
- Improve proficiency against irregular challenges
- Increase capabilities of partners, both international and domestic

New Warfare Concepts

The Department's Joint Concept Development and Experimentation Plan aims to rapidly convert innovative joint warfighting concepts into prototypes and fielded capabilities. New concepts put into practical use can provide America's warfighters with an advantage to defeat adversaries. The plan follows two paths:

- The Joint Concept Development Program explores innovative concepts for improving future joint warfighting. These concepts can result from small-scale experiments conducted in a joint war-gaming environment. They can

be developed and incorporated into large-scale experimentation programs. Experimentation with these concepts will lead to capabilities for the joint warfighter. The program provides recommendations for investments based on experimentation results.

- The Joint Prototype Program improves current warfighting capabilities and refines new capabilities through continuous experimentation. The program identifies capability proposals for rapid prototyping and provides recommendations for future resource investments based on experimentation results.

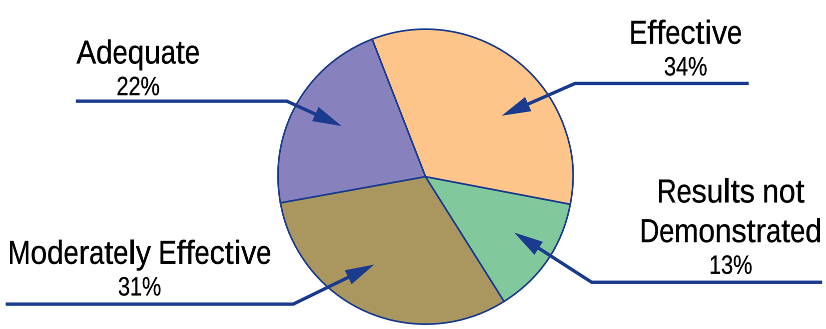
Joint Operations Concepts have been developed to guide the transformation of the joint force so that it is prepared to operate successfully 8 to 20 years in the future. The concepts present a detailed description of how future operations may be conducted and provide the basis for joint experimentation.

Program Assessment Rating Tool Summary

The Office of Management and Budget developed the Program Assessment Rating Tool (PART) to assess and improve program performance. The PART is used within the Department to provide a systematic approach for rating programs by analyzing whether a program has a clear definition of success, uses strong management practices, and produces results. A PART review helps identify program strengths and weaknesses to make informed funding and management decisions aimed at making the program more effective. It looks at all factors that affect and reflect program performance including program purpose and design; performance measurement, evaluations, and strategic planning; program management; and program results. The PART includes a series of analytical questions that enable programs to show improvements over time, and allow comparisons between similar programs.

A summary of the Department's PART ratings is included in budget submissions to help integrate budget and performance. The following figure provides a breakout of the overall ratings for the Department's PART programs. Approximately 60 percent of the Department's programs were rated for FY 2005.

The Department's Programs by PART Performance Rating Category



In FY 2005, the Office of Management and Budget provided "favorable" PART ratings to 87 percent of the Department's 32 programs assessed. Of the possible favorable ratings, 11 programs, 34 percent, were rated "effective." An effective rating is the highest rating a program can receive; programs rated at this level are considered to have ambitious goals, achieved results and efficiencies, and implemented effective management practices. The Department's programs rated at this level include the Military Force Management, Navy/Marine Corps Air Operations, and Defense Basic Research. Ten programs, 31 percent, were rated "moderately effective," which is the second highest rating. Programs rated moderately effective include the Defense Housing, Air Combat Program, and the Department's Unmanned Aircraft Systems Program. Seven programs were rated "adequate," representing 22 percent of the favorable ratings.

In FY 2005, none of the Department's programs were rated "ineffective" by the Office of Management and Budget. This is a significant improvement over the 13 percent of programs that were rated "ineffective" in FY 2004. In FY 2005, 13 percent of the Department's programs were rated "results not demonstrated." This rating concludes that additional performance goals and data collection procedures are required to provide further evidence of improved performance. In these cases, the Department has detailed improvement plans to correct program deficiencies that will increase program effectiveness. As examples, the Defense Communications Infrastructure program began taking action to develop common metrics to assess program performance across the Department. The Defense Small Business Innovation Research and Technology Transfer program is changing the way small companies' past performance is assessed to match legislative intent. The Department of Defense Training and Education Programs for Other Training and Education is identifying specific program goals, developing performance measurements, and establishing ambitious targets.

The following tables show how PART programs align with the Department's strategic goals and the budget for each program. Of the Department's FY 2005 budget, $286 billion or 59 percent is dedicated to programs that have been rated.

Strategic Goal 1: Balance Force Management Risk – Recruit, Retain, Train, and Equip a Ready Force and Sustain Readiness	Program	FY 2005 Funding (in Millions)	Score
	Air Force Aircraft Operations	$6,455	Effective
	Army Land Forces Operations	$2,495	Effective
	Defense Health Care	$20,021	Adequate
	Navy Ship Operations	$5,186	Effective
	Defense Housing	$17,047	Moderately Effective
	Department of Defense Education Activity	$1,776	Moderately Effective
	Department of Defense Recruiting	$3,973	Moderately Effective
	Department of Defense Training and Education Programs - Accession Training	$829	Moderately Effective
	Department of Defense Training and Education Programs - Basic Skills and Advanced Training	$4,957	Effective
	Department of Defense Training and Education Programs - Other Training and Education	$1,210	Results Not Demonstrated
	Military Force Management	$113,649	Effective
	Subtotal	$177,598	

	Program	FY 2005 Funding (in Millions)	Score
Strategic Goal 2: Balance Operational Risk – Achieve and Maintain Operational Superiority	Air Combat Program	$11,783	Moderately Effective
	Airlift Program	$5,771	Moderately Effective
	Chemical Demilitarization	$1,387	Adequate
	Defense Air Transportation System	$7,482	Moderately Effective
	Defense Communications Infrastructure	$3,820	Results Not Demonstrated
	The Department of Defense Unmanned Aircraft Systems	$1,588	Moderately Effective
	Marine Corps Expeditionary Warfare	$10,223	Results Not Demonstrated
	Navy/Marine Corps Air Operations	$5,795	Effective
	Space Launch	$1,175	Adequate
	Navy Shipbuilding	$13,778	Adequate
	Subtotal	$62,802	
Strategic Goal 3: Balance Institutional Risk – Align the Organization and its Resources to Support the Warfighter	Air Force Depot Maintenance	$3,533	Effective
	Department of Defense Depot Maintenance: Ship	$4,042	Effective
	Department of Defense Facilities Sustainment, Restoration, Modernization, and Demolition	$11,366	Adequate
	Depot Maintenance - Naval Aviation	$977	Effective
	Energy Conservation Investment	$50	Effective
	Subtotal	$19,968	
Strategic Goal 4: Balance Future Challenges Risk – Execute Future Missions Successfully Against an Array of Prospective Challengers	Defense Basic Research	$1,476	Effective
	Defense Small Business Innovation Research/ Technology Transfer	$1,264	Results Not Demonstrated
	Future Combat Systems/Modularity Land Warfare	$9,623	Moderately Effective
	Missile Defense	$7,695	Adequate
	National Security Space Weather Programs	$394	Adequate
	Defense Applied Research Program	$5,188	Moderately Effective
	Subtotal	$25,640	
	Grand Total	$286,008	

Section 3:
Financial Information

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Message from the Chief Financial Officer

UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON DC 20301-1100

COMPTROLLER

November 15, 2006

The fiscal year (FY) 2006 Performance and Accountability Report highlights for the President, the Congress, and the American people, the continuing commitment of the Department of Defense to sound financial management of the resources entrusted to us for the defense of the Nation.

Indeed, since the Financial Improvement and Audit Readiness Plan (FIAR) and the Enterprise Transition Plan were released in 2005, the Department has made clear and measurable progress resolving material weaknesses, improving financial practices, strengthening internal controls, and modernizing business systems and processes. We have reduced the cost of operations, increased speed and efficiency, improved financial accountability and, most importantly, positively impacted our primary mission: supporting the brave men and women of America's Armed Forces who are today fighting to defend the Nation and its citizens against the threat of global terrorism.

In FY 2006, four new priority areas were added to our focused effort to improve financial information and achieve audit readiness. In addition to Military Equipment, Real Property, Medicare-Eligible Retiree Health Care Fund, and Environmental Liabilities, which represent a significant portion of the Department's assets and liabilities, Accounts Payable, Accounts Receivable, Inventory, and Operating Material and Supplies, were added this past September.

Also in FY 2006, financial statements for the Army Corps of Engineers were audited, and the Department of the Air Force asserted that its Fund Balance with Treasury is ready for audit. We completed a baseline valuation for all military equipment programs, which represent 25 percent of the Department's assets, and completed an initial inventory and estimate for the Department's environmental liabilities.

In addition, the Standard Financial Information Structure, a common business language that will facilitate the accurate compilation and reporting of financial information, was implemented, and an incremental approach to implementing the Office of Management and Budget Circular A-123, Appendix A, developed. This new approach will leverage, to the greatest extent possible, initiatives such as the FIAR Plan and other management tools and documentation. Additional accomplishments and a discussion of the Department's short-term goals can be found in Section 1, Management's Discussion and Analysis, of this report.

In recognition of these and other efforts, the Office of Management and Budget raised the Department's progress score on the President's Management Agenda for Improved Financial Performance to "green." The Department's status score for Improved Financial Performance continues to be rated "red," however the "green" progress score indicates that the Department is making steady progress in financial management.

While our work is far from complete, I am grateful to the Department's leaders, managers and, most of all, employees for their dedicated efforts to advance business transformation and improve the financial management of the Department of Defense.

Tina W. Jonas

Independent Auditors' Report on the Principal Statements

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202–4704

November 12, 2006

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)/CHIEF FINANCIAL OFFICER)

SUBJECT: Independent Auditor's Report on the Fiscal Year 2006 Department of Defense Agency-Wide Financial Statements (Report No. D-2007-020)

The Chief Financial Officers Act of 1990, as amended, requires the Department of Defense Inspector General to audit the accompanying DoD Agency-Wide Consolidated Balance Sheet as of September 30, 2006 and 2005, the related Consolidated Statement of Net Cost, the Consolidated Statement of Changes in Net Position, the Combined Statement of Budgetary Resources, the Consolidated Statement of Financing, and the Statement of Custodial Activity for the fiscal years then ended. The financial statements are the responsibility of DoD management. DoD is also responsible for implementing effective internal control and for complying with laws and regulations. We are unable to give an opinion on the DoD Fiscal Year 2006 financial statements because of limitations on the scope of our work. Thus, the financial statements may be unreliable. In addition to our disclaimer of opinion on the financial statements, we are including the required Report on Internal Control and Compliance with Laws and Regulations. The Report on Internal Control and Compliance with Laws and Regulations is an integral part of our disclaimer of opinion on the financial statements and should be considered in assessing the results of the audit.

Disclaimer of Opinion on the Financial Statements

The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged to us that the FY 2006 DoD Agency-Wide Financial Statements would not substantially conform to generally accepted accounting principles, and DoD financial management and feeder systems were unable to adequately support material amounts on the financial statements as of September 30, 2006. Therefore, we did not perform auditing procedures to determine whether material amounts on the financial statements were fairly presented. We did not perform these and other auditing procedures because Section 1008(d) of the FY 2002 National Defense Authorization Act limits the Department of Defense Inspector General to perform only audit procedures required by generally accepted government auditing standards that are consistent with the representations made by management. DoD has also acknowledged, and prior audits have identified, the long-standing material weaknesses listed in the Summary of Internal Control. These pervasive material weaknesses also affect the reliability of certain information contained in the annual financial statements—much of which is taken from the same data sources as the basic financial statements.[1] Therefore, we are unable to express, and we do not express, an opinion on the basic financial statements. Additionally, the purpose of the audit was not to express an opinion on the information accompanying the basic financial statements. Accordingly, we express no opinion on the accompanying information.

[1] The annual financial statements include the basic financial statements, management discussion and analysis, consolidating and combining financial statements, Required Supplementary Stewardship Information, Required Supplementary Information, and Other Accompanying Information.

Summary of Internal Control

In planning our audit, we considered DoD internal control over financial reporting and compliance. We did this to determine our procedures for auditing the financial statements and to comply with Office of Management and Budget guidance, but our purpose was not to express an opinion on internal control. Accordingly, we do not express an opinion on internal control over financial reporting and compliance. However, previously identified reportable conditions, all of which are material, continued to exist in the following areas:

- Financial Management Systems
- Fund Balance With Treasury
- Inventory
- Operating Materials and Supplies
- General Property, Plant, and Equipment
- Government-Furnished Material and Contractor-Acquired Material
- Environmental Liabilities
- Intragovernmental Eliminations
- Accounting Entries
- Statement of Net Cost
- Statement of Financing

We identified the following additional material weakness in FY 2006:

- Accounts Payable

Material weaknesses are reportable conditions in which internal controls do not reduce (to a relatively low level) the risk of misstatements that are material to the financial statements and that might not be timely detected by employees while performing their normal assigned functions.

Reportable conditions are matters coming to the auditor's attention that, in his or her judgment, should be communicated to management because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in financial statements.

Our internal control work (conducted during prior audits) would not necessarily disclose all reportable conditions. The Attachment offers additional details on reportable conditions, most of which we consider to be material internal control weaknesses.

Additionally, DoD provided a qualified statement of assurance for the internal controls over financial reporting in the FY 2006 PAR. We consider the qualified statement of assurance for the internal controls over financial reporting to be misleading because the qualified statement of assurance does not accurately reflect the results of the assessments that DoD conducted in order to meet the requirements of Office of Management and Budget (OMB) Circular No. A-123, "Revisions to OMB Circular A-123, Management's Responsibility for Internal Control," December 21, 2004, Appendix A. Based on (1) the material internal control weaknesses that continue to exist; (2) management's acknowledgement that DoD's financial statements do not conform to generally accepted accounting principles; and (3) the continued existence of DoD's financial management system deficiencies, a statement of no assurance that the internal controls over financial reporting were operating effectively would be more appropriate. The statement of no assurance on the internal controls over financial reporting would reflect more clearly the level of assurance that management can provide considering the pervasive material weaknesses that affect the reliability of the DoD financial statements.

Summary of Compliance with Laws and Regulations

Our work to determine compliance with selected provisions of applicable laws and regulations related to financial reporting was limited because management acknowledged, and prior audits confirm, that instances of noncompliance continue to exist. The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged to us that DoD financial management systems do not substantially comply with Federal financial management system requirements, generally accepted accounting principles, and the U.S. Government Standard General Ledger at the transaction level. Therefore, we did not determine whether DoD was in compliance with all applicable laws and regulations related to financial reporting. Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion. See the Attachment for additional details on compliance with laws and regulations.

Management's Responsibilities

Management is responsible for:

- preparing the financial statements in conformity with generally accepted accounting principles;
- establishing, maintaining, and assessing internal controls to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act are met; and
- complying with applicable laws and regulations.

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We provided a draft of this report to personnel in the Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer who provided technical comments, which have been incorporated as appropriate. DoD officials expressed their continuing commitment to address the problems this report outlines.

Paul J. Granetto, CPA
Assistant Inspector General and Director
Defense Financial Auditing Service

Attachment:
As stated

Report on Internal Control and Compliance with Laws and Regulations

Internal Control

Management is responsible for implementing and maintaining effective internal control and for providing reasonable assurance that accounting data are accumulated, recorded, and reported properly; the requirements of applicable laws and regulations are met; and assets are safeguarded against misappropriation and abuse. Our purpose was not to, and we do not, express an opinion on internal control over financial reporting. However, we have identified the following material weaknesses and reportable conditions that could adversely affect a favorable opinion on internal control.

Material Weaknesses. Management acknowledged that previously identified reportable conditions, all of which are material, continue to exist.

Financial Management Systems. Statement of Federal Financial Accounting Concepts No. 1, "Objectives of Federal Financial Reporting," requires financial management system controls that are adequate to ensure that transactions are executed in accordance with budgetary and financial laws and other requirements, are consistent with the purposes authorized, and are recorded in accordance with Federal accounting standards. Statement of Federal Financial Accounting Concepts No. 1 also requires that financial management system controls ensure assets are properly safeguarded to deter fraud, waste, and abuse; and that performance measurement information is adequately supported. The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged that DoD financial management and feeder systems do not substantially comply with Federal financial management system requirements. DoD financial management and feeder systems were not designed to adequately support various material amounts on the financial statements. These systemic deficiencies in financial management and feeder systems, and inadequate DoD business processes, result in the inability to collect and report financial and performance information that is accurate, reliable, and timely.

In addition, reviews of five DoD financial management systems and Defense Information Systems Agency Computing Services identified several common vulnerabilities. Controls over security planning, access controls, and software controls did not comply with DoD information assurance requirements. As a result, potential system and procedural vulnerabilities threatened the confidentiality, integrity, and availability of financial data.

Fund Balance With Treasury. The U.S. Treasury Financial Manual and DoD Financial Management Regulation 7000.14-R require DoD to resolve financial and accounting inconsistencies to accurately report Fund Balance With Treasury. However, inconsistencies continue to exist related to in-transit disbursements, unmatched disbursements, negative unliquidated obligations, unreconciled differences in suspense accounts, and unreconciled differences between U.S. Treasury records and DoD accounting records.

Inventory. Statement of Federal Financial Accounting Standards No. 3, "Accounting for Inventory and Related Property," requires DoD to use historical cost, the latest acquisition cost (adjusted for holding gains and losses), or moving average cost for valuing inventory. However, DoD acknowledged that the existing inventory value for most activities is not reported in accordance with generally accepted accounting principles and the Department's legacy systems do not maintain the historical cost data necessary to comply with Statement of Federal Financial

Attachment

Accounting Standards No. 3. Additionally, DoD does not distinguish between Inventory Held for Sale and Inventory Held in Reserve for Future Sale, as required by Statement of Federal Financial Accounting Standards No. 3.

Operating Materials and Supplies. Statement of Federal Financial Accounting Standards No. 3, "Accounting for Inventory and Related Property," states that Operating Materials and Supplies must be expensed when the items are consumed. DoD has acknowledged that significant amounts of Operating Materials and Supplies were expensed when purchased instead of when consumed.

General Property, Plant, and Equipment. Statement of Federal Financial Accounting Standards No. 6, "Accounting for Property, Plant, and Equipment," requires DoD to record General Property, Plant, and Equipment at acquisition cost, capitalize improvement costs, and recognize depreciation expense. However, the cost and depreciation of the DoD General Property, Plant, and Equipment is not reliably reported due to: (1) an accounting requirement that classified military equipment as General Property, Plant, and Equipment (such costs were previously expensed); (2) a lack of supporting documentation for General Property, Plant, and Equipment, which were purchased many years ago; and (3) most legacy property and logistics systems that are not integrated with acquisition and financial systems and were not designed to capture the acquisition cost and the cost of modifications and upgrades, or to calculate depreciation. DoD has acknowledged that it does not currently meet Federal Accounting Standards for the financial reporting of personal property, and documentation for personal property is neither accurate nor reliable. In addition, DoD does not have adequate internal controls in place to provide reasonable assurance that real property assets are identified and properly reported in its financial reports. DoD has also acknowledged that its inability to accurately report the value of military equipment supports the probability that the financial statements are materially misstated.

Government-Furnished Material and Contractor-Acquired Material. Statement of Federal Financial Accounting Standards No. 11, "Amendments to Accounting for Property, Plant, and Equipment," requires that property and equipment in the possession of a contractor for use in accomplishing a contract be considered Government property. Government property should be accounted for based on the nature of the item, regardless of who has possession. DoD has acknowledged that it is unable to comply with applicable requirements for Government-Furnished Materials and Contractor Acquired-Materials. As a result, the value of DoD property and material in the possession of contractors is not reliably reported.

Environmental Liabilities. DoD acknowledged that its internal controls for reporting environmental liabilities do not provide reasonable assurance that cleanup costs for all of its ongoing, inactive, closed, and disposal operations are identified, consistently estimated, and appropriately reported. In addition, guidance and audit trails for estimating environmental liabilities are insufficient, and the inventory of ranges and operational activities is incomplete. DoD has also acknowledged uncertainty regarding the accounting estimates used to calculate the reported Environmental Liabilities.

Intragovernmental Eliminations. DoD disclosed that it cannot accurately identify most of its intragovernmental transactions by customer because the Department's systems do not track buyer and seller data needed to match related transactions. In addition, the Department is unable to fully reconcile intragovernmental transactions with all Federal partners. DoD acknowledged that its inability to reconcile most intragovernmental transactions results in adjustments that cannot be fully supported. For example, Defense Finance and Accounting Service Indianapolis Operations made $32.1 billion in unsupported adjustments to intragovernmental accounts to force the accounts to agree with the records of Army's trading partners.

Attachment

Other Accounting Entries. DoD acknowledged that it continues to enter material amounts of unsupported accounting entries. For example, Defense Finance and Accounting Service Indianapolis recorded $270.1 billion in unsupported accounting entries to prepare the FY 2006 Army General Fund Financial Statements.

Statement of Net Cost. Statement of Federal Financial Accounting Standards Concepts No. 2, "Entity and Display," requires the Statement of Net Cost to provide an understanding of the net costs of each organization and each program. In addition, the Statement of Net Cost should provide gross and net cost information that can be related to the amounts of outputs and outcomes for the programs and organization. DoD acknowledged the following deficiencies related to the Statement of Net Cost.

- The amounts presented for General Funds may not report actual accrued costs.
- Although the funds are generally recorded on an accrual basis for Working Capital Funds, as is required by generally accepted accounting principles, the systems do not always capture actual costs in a timely manner.
- The Statement of Net Cost is not presented by programs that align with major goals and outputs described in the DoD's strategic and performance plans required by the Government Performance and Results Act.
- Revenues and expenses are reported by appropriation categories because financial processes and systems do not collect costs in line with performance measures.

Statement of Financing. Statement of Federal Financial Accounting Standards No. 7, "Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting," states that the Statement of Financing should reconcile resources obligated during the period to the net cost of operations. However, DoD acknowledged that it is unable to reconcile budgetary obligations to net costs without making unsupported adjustments. Specifically, budgetary data do not agree with proprietary expenses and capitalized assets. DoD disclosed in Note 21 that to bring the Statement of Financing into balance with the Statement of Net Cost, an adjustment of $11.3 billion (absolute value) was made.

Accounts Payable. Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," states, "a liability is recognized when one party receives goods or services in return for a promise to provide money or other resources in the future." DoD acknowledged that it does not meet accounting standards for the financial reporting of public accounts payable because of its inability to support balances due to a lack of standard procedures for recording, reporting, and reconciling the amounts between the financial, accounting, and reporting systems. DoD also acknowledged Accounts Payable as a systemic weakness in its FY 2006 Annual Statement of Assurance. Additionally, the Independent Auditor's Report on five DoD Components, namely, Army General and Working Capital Funds, Navy General and Working Capital Funds, and the U.S. Army Corps of Engineers, Civil Works, each identified Accounts Payable as a material weakness. These Components comprised over 50 percent of the DoD-Wide combined reported Accounts Payable balance as of September 30, 2006.

Attachment

Other Reportable Conditions. During FY 2006, we noted deficiencies related to Accounts Receivable and Contingent Legal Liabilities.

Accounts Receivable. Statement of Federal Financial Accounting Standards No. 1, "Accounting for Selected Assets and Liabilities," states, "A receivable should be recognized when a Federal entity establishes a claim to cash or other assets against other entities, either based on legal provisions,…or goods and services provided." DoD has acknowledged weaknesses in Accounts Receivable because its policy is not always followed when recording, reporting, collecting, and reconciling accounts receivable. Also, our reports on Internal Control for the FY 2006 Navy General Fund, Navy Working Capital Fund, Army General Fund, and the U.S. Army Corps of Engineers, Civil Works, showed deficiencies such as inadequate audit trails and reconciliations with subsidiary records, and a general lack of controls to ensure that Accounts Receivable balances are supportable at the transaction level.

Contingent Legal Liabilities. Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," as amended by Statement of Federal Financial Accounting Standards No. 12, requires contingent legal liabilities to be disclosed if there is at least a reasonable possibility that a loss may be incurred. We noted that significant weakness continued to exist relating to the DoD process for reporting contingent legal liabilities. For example:

- DoD excluded from its legal representation letters at least 55 pending cases with a total claim amount of $2.4 billion that individually did not exceed the DoD Agency-Wide individual reporting threshold, but in aggregate exceeded this threshold.

- Note 16 to the financial statements stated that there was a remote probability of an adverse decision against DoD for 65 legal actions, totaling approximately $484 billion. We were unable to corroborate this statement; however, we noted that the legal representation letters from the DoD Office of General Counsel showed that DoD General Counsel was unable to express an opinion on the likely outcome of 55 of the 65 pending legal actions, totaling $357 billion.

These financial management deficiencies are indications of material weaknesses and reportable conditions in internal control that may adversely affect any decision by DoD that is based, in whole or in part, on information that is inaccurate because of these deficiencies. Financial information reported by DoD may also contain misstatements resulting from these deficiencies.

Attachment

Compliance with Laws and Regulations

Management is responsible for complying with existing laws and regulations related to financial reporting. Our work to determine compliance with selected provisions of the applicable laws and regulations was limited because management acknowledged instances of noncompliance, and previously reported instances of noncompliance continue to exist. Therefore, we did not determine whether DoD was in compliance with selected provisions of all applicable laws and regulations related to financial reporting. Our objective was not to, and we do not, express an opinion on compliance with applicable laws and regulations.

Federal Financial Management Improvement Act of 1996. The Federal Financial Management Improvement Act of 1996 requires DoD to establish and maintain financial management systems that comply substantially with Federal financial management system requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. The Federal Financial Management Improvement Act also requires DoD to develop a remediation plan when its financial management systems do not comply with Federal financial management system requirements. The remediation plan is to include remedies, resources, and milestones. For FY 2006, DoD did not fully comply with the Federal Financial Management Improvement Act. DoD acknowledged that many of its critical financial management and feeder systems did not substantially comply with Federal financial management system requirements, Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level as of September 30, 2006.

Government Performance and Results Act. Congress enacted the Government Performance and Results Act of 1993 (The Act) to establish strategic planning and performance measurement in the Federal Government Strategic plans, annual performance plans, and annual program performance reports comprise the main elements of The Act. DoD did not fully comply with the requirements of the Government Performance and Results Act and subsequent implementation guidance in Office of Management and Budget Circular A-11, "Preparation Submission and Execution of the Budget." Specifically, DoD did not have a compliant strategic plan for FY 2006 because DoD designated the Quadrennial Defense Review report, which was prepared to fulfill the specific legislative requirements for a Quadrennial Defense Review as its strategic plan without considering other requirements specified in The Act. As a result, the DoD performance budget and performance report for FY 2006 did not comply with the requirements of the Government Performance and Results Act and Office of Management and Budget Circular A-11.

Antideficiency Act. Section 1341, title 31, United States Code limits DoD, and its agents, to only make or authorize expenditures or obligations that do not exceed the amount available in the appropriations or funds for the expenditures or obligations. Additionally, DoD and its agents, may not contract or obligate for the payment of money before an appropriation is made available for that contract or obligation unless otherwise authorized by law. Section 1341, title 31, United States Code states if an officer or employee of an executive agency violates the Antideficiency Act, the head of the agency must report immediately to the President and Congress all relevant facts and a statement of the actions taken. During FY 2006, DoD reported nine cases where actual violations of the Antideficiency Act occurred. Therefore, DoD did not comply with section 1341, title 31, United States Code.

DoD internal guidance limits the time from identification to reporting violations of the Antideficiency Act to 12 months. Our review of DoD Antideficiency Act investigations of potential violations shows that DoD did not process Antideficiency Act violation cases within the 12-month time limit.

Attachment

Officials and employees of the Federal Government who violate the Antideficiency Act are subject to disciplinary action. DoD Financial Management Regulation 7000.14-R defines such disciplinary action to include written admonishment or reprimand, reduction in grade, suspension from duty without pay, or removal from office. However, our review of the statements of disciplinary officers for those disciplined for violating the Antideficiency Act identified that the disciplinary action was not always consistent with the DoD Financial Management Regulation.

Prompt Payment Act. The Prompt Payment Act requires the payment date for an invoice to be the date payment is due under the contract or 30 days after a proper invoice is received if a specific payment date is not established by the contract. The Prompt Payment Act also states that an agency must make payments no more than 7 days prior to the payment due date unless the agency head or designee has determined (on a case-by-case basis) that earlier payment is necessary. However, Defense Financial Accounting Service Columbus records showed that most of the interim payments on cost-reimbursement service contracts disbursed in FY 2005 through the Mechanization of Contract Service system were paid earlier than 7 days prior to the due date the system calculated.

Specifically, Defense Financial Accounting Service Columbus disbursed approximately $28.4 billion, representing 90 percent of the invoices and 88 percent of the disbursements, in interim payments on cost-reimbursement service contracts earlier than permitted by the Prompt Payment Act. Defense Financial Accounting Service Columbus paid these invoices early because it implemented Federal and DoD policies that conflicted with the Prompt Payment Act and contributed to a calculated $9.4 million in lost Federal interest based on the Treasury Current Value of Funds rate.

Improper Payments Information Act. DoD does not fully comply with the requirements of the Improper Payments Information Act of 2002, Public Law 107-300, and subsequent Office of Management and Budget guidance. Although it reported $22.5 million in improper payments related to the procurement of fuel in FY 2005, the Defense Finance and Accounting Service Columbus and the Defense Energy Support Center did not have adequate control processes in place to provide reasonable assurance that the amount reported was accurate. Furthermore, the Government Accountability Office believes that programs related to military pay, travel, property, contract payments, and automated systems may be at risk of making significant improper payments. Although DoD recently received a score of "yellow," signaling mixed results for implementing improper payments on the President's Management Agenda, DoD has taken steps to resolve some previously identified issues regarding the methodologies and processes used in reporting improper payments. Through coordination with the DoD Office of Inspector General, DoD has recently issued a policy establishing a Project Officer for Improper Payments and Recovery Auditing to review DoD's statistical methodologies and processes, and to verify DoD reporting information is accurate, complete, and meets or exceeds Office of Management and Budget minimum reporting requirements. Finally, the Project Officer will also establish an ongoing Improper Payments and Recovery Auditing working group to help DoD modify improper payment methodologies and processes as needed.

Audit Disclosures

The Under Secretary of Defense (Comptroller)/Chief Financial Officer acknowledged to us on June 30, 2006, that the DoD financial management and feeder systems cannot provide adequate evidence supporting various material amounts on the financial statements. Therefore, we did not perform detailed testing related to previously identified material weaknesses. In addition, we did

Attachment

not perform audit work related to the following selected provisions of laws and regulations: Provisions Governing Claims of the United States Government (including provisions of the Debt Collection Improvement Act), Federal Credit Reform Act, and the Pay and Allowance System for Civilian Employees.

This report does not include recommendations to correct the material internal control weaknesses and instances of noncompliance because previous audit reports contained recommendations for corrective actions, or audit projects currently in process will include appropriate recommendations.

Attachment

Principal Financial Statements And Notes

The principal financial statements included in this report have been prepared in accordance with the requirements of the Chief Financial Officers Act of 1990, the Government Management Reform Act of 1994, and the Office of Management and Budget's Circular A-136, "Financial Reporting Requirements." The responsibility for the integrity of the financial information included in these statements rests with the management of the Department of Defense. The Department's fiscal years 2006 and 2005 principal financial statements were audited by the Office of Inspector General. The auditors' report accompanies the principal statements.

The Department's principal financial statements for fiscal years 2006 and 2005 consisted of the following:

The Balance Sheet

The Balance Sheet, which presents as of September 30, 2006 and 2005 those resources owned or managed by the Department which are available to provide future economic benefits (assets); amounts owed by the Department that will require payments from those resources or future resources (liabilities); and residual amounts retained by the Department, comprising the difference (net position).

The Statement of Net Cost

The Statement of Net Cost, which presents the net cost of the Department's operations for the years ended September 30, 2006 and 2005. The Department's net cost of operations includes the gross costs incurred by the Department less any exchange revenue earned from Department activities.

The Statement of Changes in Net Position

The Statement of Changes in Net Position, which presents the change in the Department's net position resulting from the net cost of the Department's operations, budgetary financing sources other than exchange revenues, and other financing sources for the years ended September 30, 2006 and 2005.

The Statement of Budgetary Resources

The Statement of Budgetary Resources, which presents the budgetary resources available to the Department during FY 2006 and 2005, the status of these resources at September 30, 2006 and 2005, and the outlay of budgetary resources for the years ended September 30, 2006 and 2005.

The Statement of Financing

The Statement of Financing, which reconciles the net cost of operations with the obligation of budgetary resources for the years ended September 30, 2006 and 2005.

The Statement of Custodial Activity

The Statement of Custodial Activity, which presents the sources and disposition of nonexchange revenues collected or accrued by the Department on behalf of other recipient entities for the years ended September 30, 2006 and 2005.

Principal Financial Statements

CONSOLIDATED BALANCE SHEET

Department of Defense

As of September 30, 2006 and 2005

($ in millions)

	2006	2005 Restated
Assets (Note 2)		
Intragovernmental		
Fund Balance with Treasury (Note 3)	$ 327,138.3	$ 290,657.1
Investments and Related Interest (Note 4)	299,261.2	263,367.8
Accounts Receivable, Net (Note 5)	2,927.4	1,291.3
Other Assets (Note 6)	1,189.6	1,519.1
Total Intragovernmental Assets	630,516.5	556,835.3
Cash and Other Monetary Assets (Note 7)	2,199.8	2,072.7
Accounts Receivable, Net (Note 5)	7,864.1	7,615.5
Loans Receivable (Note 8)	191.7	75.6
Inventory and Related Property, Net (Note 9)	231,823.2	222,573.3
General Property, Plant and Equipment, Net (Note 10)	465,439.5	452,541.4
Investments and Related Interest (Note 4)	1,089.8	605.0
Other Assets (Note 6)	27,928.7	23,822.1
Total Assets	**$ 1,367,053.3**	**$ 1,266,140.9**
Liabilities (Note 11)		
Intragovernmental		
Accounts Payable (Note 12)	$ 1,549.8	$ 2,058.0
Debt (Note 13)	382.1	467.1
Other Liabilities (Notes 15 and 16)	12,822.2	11,150.8
Total Intragovernmental Liabilities	14,754.1	13,675.9
Accounts Payable (Note 12)	27,320.9	28,575.4
Military Retirement and Other Federal Employment Benefits (Note 17)	1,815,769.5	1,736,057.8
Environmental and Disposal Liabilities (Note 14)	69,985.1	65,027.6
Loan Guarantee Liability (Note 8)	36.8	41.1
Other Liabilities (Notes 15 and 16)	31,566.1	29,985.4
Total Liabilities	1,959,432.5	1,873,363.2
Net Position		
Unexpended Appropriations - Earmarked Funds (Note 23)	11.4	-
Unexpended Appropriations - Other Funds	307,698.0	271,493.6
Cumulative Results of Operations - Earmarked Funds	(1,271,684.5)	-
Cumulative Results of Operations - Other Funds	371,595.9	(878,715.9)
Total Net Position	(592,379.2)	(607,222.3)
Total Liabilities and Net Position	**$ 1,367,053.3**	**$ 1,266,140.9**

The accompanying notes are an integral part of these financial statements.

CONSOLIDATED STATEMENT OF NET COST

Department of Defense

For the years ended September 30, 2006 and 2005

($ in millions)

	2006	2005
Program Costs		
Gross Costs	$ 629,736.4	$ 680,086.6
Less: Earned Revenue	(48,350.3)	(45,207.1)
Net Program Costs	581,386.1	634,879.5
Cost Not Assigned to Programs	-	-
Less: Earned Revenue Not Attributable to Programs	-	-
Net Cost of Operations	**$ 581,386.1**	**$ 634,879.5**

The accompanying notes are an integral part of these financial statements.

CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION

Department of Defense
As of September 30, 2006 and 2005
($ in millions)

	FY 2006		
	Earmarked Funds	All Other Funds	Eliminations
Cumulative Results of Operations			
Beginning Balances	$ (1,170,876.1)	$ 300,193.3	$ -
Prior Period Adjustments:			-
Changes in Accounting Principles	-	-	-
Correction of Errors	-	(8,033.1)	-
Beginning Balances, as adjusted	(1,170,876.1)	292,160.2	-
Budgetary Financing Sources			
Appropriations used	2.1	548,113.6	-
Nonexchange revenue	3,037.2	19.9	-
Donations and forfeitures of cash and cash equivalents	25.4	-	-
Transfers in(out) without reimbursement	225.7	732.8	-
Other budgetary financing sources	0.6	-	-
Other Financing Sources (Non-Exchange)			
Donations and forfeitures of property	-	47.3	-
Transfers in(out) without reimbursement	(152.4)	135.7	-
Imputed financing from costs absorbed by others	-	4,409.6	-
Other	(25.0)	3,440.9	-
Total Financing Sources	3,113.6	556,899.8	-
Net Cost of Operations	39,006.8	542,379.3	-
Net Change	(35,893.2)	14,520.5	-
Cumulative Results of Operations	**$ (1,206,769.3)**	**$ 306,680.7**	**$ -**
Unexpended Appropriations			
Beginning Balances	$ 13.4	$ 271,480.2	$ -
Prior Period Adjustments:			
Changes in accounting principles	-	-	-
Corrections of errors	-	-	-
Beginning balances, as adjusted	13.4	271,480.2	-
Budgetary Financing Sources			
Appropriations received	0.1	594,653.4	-
Appropriations transferred in(out)	-	(146.8)	-
Other adjustments (rescissions, etc)	-	(10,175.2)	-
Appropriations used	(2.1)	(548,113.6)	-
Total Budgetary Financing Sources	(2.0)	36,217.8	-
Total Unexpended Appropriations	**11.4**	**307,698.0**	**-**
Net Position	**$ (1,206,757.9)**	**$ 614,378.7**	**$ -**

The accompanying notes are an integral part of these financial statements.

CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION

Department of Defense
As of September 30, 2006 and 2005
($ in millions)

	2006 Consolidated Total	2005 Consolidated Total Restated
Cumulative Results of Operations		
Beginning Balances	$ (870,682.8)	$ (745,441.3)
Prior Period Adjustments:		
Changes in Accounting Principles	-	3,632.4
Correction of Errors	(8,033.1)	(776.5)
Beginning Balances, as adjusted	(878,715.9)	(742,585.4)
Budgetary Financing Sources		
Appropriations used	548,115.7	491,580.5
Nonexchange revenue	3,057.1	1,665.0
Donations and forfeitures of cash and cash equivalents	25.4	42.6
Transfers in(out) without reimbursement	958.5	3,176.4
Other budgetary financing sources	0.6	0.5
Other Financing Sources (Non-Exchange)		
Donations and forfeitures of property	47.3	1.5
Transfers in(out) without reimbursement	(16.7)	(14.3)
Imputed financing from costs absorbed by others	4,409.6	4,465.3
Other	3,415.9	(2,168.5)
Total Financing Sources	560,013.4	498,749.0
Net Cost of Operations	581,386.1	634,879.5
Net Change	(21,372.7)	(136,130.5)
Cumulative Results of Operations	**$ (900,088.6)**	**$ (878,715.9)**
Unexpended Appropriations		
Beginning Balances	$ 271,493.6	$ 243,813.9
Prior Period Adjustments:		
Changes in accounting principles	-	-
Corrections of errors	-	-
Beginning balances, as adjusted	271,493.6	243,813.9
Budgetary Financing Sources		
Appropriations received	594,653.5	524,990.1
Appropriations transferred in(out)	(146.8)	(651.7)
Other adjustments (rescissions, etc)	(10,175.2)	(5,078.2)
Appropriations used	(548,115.7)	(491,580.5)
Total Budgetary Financing Sources	36,215.8	27,679.7
Total Unexpended Appropriations	**307,709.4**	**271,493.6**
Net Position	**$ (592,379.2)**	**$ (607,222.3)**

The accompanying notes are an integral part of these financial statements.

COMBINED STATEMENT OF BUDGETARY RESOURCES

Department of Defense

For the Years Ended September 30, 2006 and 2005

($ in millions)

	2006	
	Budgetary Financing Accounts	**Non-Budgetary Credit Reform Financing Accounts**
Budgetary Resources		
Unobligated balance, brought forward, October 1	$ 68,589.5	$ 35.0
Recoveries of prior year unpaid obligations	30,242.2	-
Budget Authority:		
Appropriations received	681,682.7	-
Borrowing authority	-	93.8
Contract authority	59,451.7	-
Spending authority from offsetting collections:		
Earned:		
Collected	164,717.5	58.5
Receivable from federal sources	649.0	-
Change in unfilled customer orders:		
Advanced received	313.9	-
Without advance from federal sources	179.1	(46.8)
Subtotal	906,993.9	105.5
Nonexpenditure transfers, net, anticipated and actual	(182.2)	-
Temporarily not available pursuant to Public Law	(35,746.3)	-
Permanently not available	(71,854.5)	(0.1)
Total Budgetary Resources	**$ 898,042.6**	**$ 140.4**
Status of Budgetary Resources		
Obligations Incurred:		
Direct	$ 646,432.0	$ 108.9
Reimbursable	165,521.3	-
Subtotal	811,953.3	108.9
Unobligated balance:		
Apportioned	74,622.3	0.5
Exempt from apportionment	1,220.4	-
Subtotal	75,842.7	0.5
Unobligated balances not available	10,246.6	31.0
Total Status of Budgetary Resources	**$ 898,042.6**	**$ 140.4**

The accompanying notes are an integral part of these financial statements.

COMBINED STATEMENT OF BUDGETARY RESOURCES

Department of Defense

For the Years Ended September 30, 2006 and 2005

($ in millions)

	2006	
	Budgetary Financing Accounts	**Non-Budgetary Credit Reform Financing Accounts**
Change in Obligated Balance		
Obligated balance, net		
Unpaid obligations, brought forward, October 1	300,445.5	446.3
Less: Uncollected customer payments from Federal sources, brought forward, October 1	(54,586.9)	(123.7)
Total unpaid obligated balance	245,858.6	322.6
Obligations incurred net	811,953.3	108.9
Less: Gross outlays	(763,627.4)	(176.8)
Obligated balance transferred, net:		
Actual transfers, unpaid obligations	-	-
Actual transfers, uncollected customer payments from federal sources	-	-
Total unpaid obligated balance transferred, net	-	-
Less: Recoveries of prior year unpaid obligations, actual	(30,242.2)	-
Change in uncollected customer payments from federal sources	(827.8)	46.8
Obligated balance, net, end of period:		
Unpaid obligations	318,529.2	378.4
Less: Uncollected customer payments from federal sources	(55,414.7)	(76.9)
Total, unpaid obligated balance, net, end of period	**263,114.5**	**301.5**
Net Outlays		
Net Outlays:		
Gross outlays	$ 763,627.4	$ 176.8
Less: Offsetting collections	(165,031.5)	(58.5)
Less: Distributed offsetting receipts	(61,978.2)	-
Net Outlays	**$ 536,617.7**	**$ 118.3**

The accompanying notes are an integral part of these financial statements.

COMBINED STATEMENT OF BUDGETARY RESOURCES

Department of Defense

For the Years Ended September 30, 2006 and 2005

($ in millions)

	2005	
	Budgetary Financing Accounts	**Non-Budgetary Credit Reform Financing Accounts**
Budgetary Resources		
Unobligated balance, brought forward, October 1	$ 73,282.9	$ 24.6
Recoveries of prior year unpaid obligations	36,376.7	-
Budget Authority:		
Appropriations received	604,969.5	-
Borrowing authority	-	170.3
Contract authority	56,753.1	-
Spending authority from offsetting collections:		
Earned:		
Collected	158,928.0	16.9
Receivable from federal sources	(18.2)	-
Change in unfilled customer orders:		
Advanced received	642.0	-
Without advance from federal sources	5,065.9	40.6
Subtotal	826,340.3	227.8
Nonexpenditure transfers, net, anticipated and actual	264.5	-
Temporarily not available pursuant to Public Law	(31,875.4)	-
Permanently not available	(58,299.7)	(2.2)
Total Budgetary Resources	**$ 846,089.3**	**$ 250.2**
Status of Budgetary Resources		
Obligations Incurred:		
Direct	$ 601,516.8	$ 215.2
Reimbursable	175,983.1	-
Subtotal	777,499.9	215.2
Unobligated balance:		
Apportioned	59,206.9	1.5
Exempt from apportionment	725.9	-
Subtotal	59,932.8	1.5
Unobligated balances not available	8,656.6	33.5
Total Status of Budgetary Resources	**$ 846,089.3**	**$ 250.2**

The accompanying notes are an integral part of these financial statements.

COMBINED STATEMENT OF BUDGETARY RESOURCES

Department of Defense

For the Years Ended September 30, 2006 and 2005

($ in millions)

	2005	
	Budgetary Financing Accounts	**Non-Budgetary Credit Reform Financing Accounts**
Change in Obligated Balance		
Obligated balance, net		
Unpaid obligations, brought forward, October 1	282,772.9	238.8
Less: Uncollected customer payments from Federal sources, brought forward, October 1	(49,538.8)	(83.1)
Total unpaid obligated balance	233,234.1	155.7
Obligations incurred net	777,499.9	215.2
Less: Gross outlays	(723,450.6)	(7.7)
Obligated balance transferred, net:		
Actual transfers, unpaid obligations	-	-
Actual transfers, uncollected customer payments from federal sources	-	-
Total unpaid obligated balance transferred, net	-	-
Less: Recoveries of prior year unpaid obligations, actual	(36,376.7)	-
Change in uncollected customer payments from federal sources	(5,048.0)	(40.6)
Obligated balance, net, end of period:		
Unpaid obligations	300,445.5	446.3
Less: Uncollected customer payments from federal sources	(54,586.9)	(123.7)
Total, unpaid obligated balance, net, end of period	**245,858.6**	**322.6**
Net Outlays		
Net Outlays:		
Gross outlays	$ 723,450.6	$ 7.7
Less: Offsetting collections	(159,570.1)	(16.9)
Less: Distributed Offsetting receipts	(55,072.9)	-
Net Outlays	**$ 508,807.6**	**$ (9.2)**

The accompanying notes are an integral part of these financial statements.

CONSOLIDATED STATEMENT OF FINANCING

Department of Defense

For the Years Ended September 30, 2006 and 2005

($ in millions)

	2006	2005
Resources Used to Finance Activities		
Bugetary Resources Obligated		
Obligations incurred	$ 812,062.2	$ 777,715.1
Less: Spending authority from offsetting collections and recoveries	(196,113.4)	(201,052.5)
Obligations net of offsetting collections and recoveries	615,948.8	576,662.6
Less: Offsetting receipts	(61,978.2)	(55,072.9)
Net Obligations	553,970.6	521,589.7
Other Resources		
Donations and forfeitures of property	$ 47.3	$ 1.5
Transfers in(out) without reimbursement	(16.7)	(14.3)
Imputed financing from costs absorbed by others	4,409.6	4,465.3
Other	3,415.9	(2,168.5)
Net other resources used to finance activities	7,856.1	2,284.0
Total resources used to finance activities	**$ 561,826.7**	**$ 523,873.7**
Resources Used to Finance Items not Part of the Net Cost of Operations		
Change in budgetary resources obligated for goods, services and benefits ordered but not yet provided		
Undelivered orders	$ (19,661.9)	$ (42,391.5)
Unfilled customer orders	446.2	5,748.6
Resources that fund expenses recognized in prior periods	(6,365.6)	(2,610.0)
Budgetary offsetting collections and receipts that do not affect Net Cost of Operations	5,091.7	3,325.1
Resources that finance the acquisition of assets	(131,868.4)	(112,714.7)
Other resources or adjustments to net obligated resources that do not affect Net Cost of Operations		
Less: Trust or Special Fund Receipts Related to Exchange	(10.0)	(10.0)
Other	(3,446.2)	2,176.3
Total resources used to finance items not part of the Net Cost of Operations	(155,814.2)	(146,476.2)
Total resources used to finance the Net Cost of Operations	**$ 406,012.5**	**$ 377,397.5**
Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period		
Components Requiring or Generating Resources in the Future Period:		
Increase in annual leave liability	$ 7,401.2	$ 615.1
Increase in environmental and disposal liability	5,632.5	1,100.3
Updward (downward) reestimates of credit subsidy expense	(2.2)	-
Increase in exchange revenue receivable from the public	(47.7)	40.5
Other	73,776.0	168,069.4
Total components of Net Cost of Operations that will require or generate resources in future periods	86,759.8	169,825.3
Components not Requiring or Generating Resources:		
Depreciation and amortization	$ 65,116.2	$ 48,944.0
Revaluation of assets and liabilities	5,174.4	1,775.1
Other		
Trust fund exchange revenue	(26,827.3)	(26,007.0)
Cost of goods sold	47,718.4	46,172.4
Operating materials and supplies used	10,062.5	246.8
Other	(12,630.4)	16,525.4
Total components of Net Cost of Operations that will not require or generate resources	88,613.8	87,656.7
Total components of Net Cost of Operations that will not require or generate resources in the current period	**175,373.6**	**257,482.0**
Net Cost of Operations	**$ 581,386.1**	**$ 634,879.5**

The accompanying notes are an integral part of these financial statements.

COMBINED STATEMENT OF CUSTODIAL ACTIVITY

Department of Defense

For the Years Ended September 30, 2006 and 2005

($ in millions)

	2006		2005	
Revenue Activity				
Sources of Cash Collections:				
Deposits by foreign governments	$	13,719.7	$	10,693.1
Seized Iraqi cash		-		-
Total cash collections	$	13,719.7	$	10,693.1
Accrual adjustments		-		-
Total custodial revenue	$	13,719.7	$	10,693.1
Disposition of Collections				
Disbursed on behalf of foreign governments and international organizations	$	12,555.1	$	11,070.7
Seized assets disbursed on behalf of Iraqi people		31.2		52.1
Increase (decrease) in amounts to be transferred		1,164.6		(377.6)
Collections used for refunds and other payments		-		-
Retained by the reporting entity		-		-
Seized assets retained for support of the Iraqi people		(31.2)		(52.1)
Total disposition of collections	$	13,719.7	$	10,693.1
Net Custodial Activity	**$**	**-**	**$**	**-**

The accompanying notes are an integral part of these financial statements.

Notes to the Principal Statements

Note 1. Significant Accounting Policies

1.A. Basis of Presentation

These financial statements have been prepared to report the financial position and results of operations of the Department, as required by the "Chief Financial Officers Act of 1990," expanded by the "Government Management Reform Act of 1994," and other appropriate legislation. The financial statements have been prepared from the books and records of the Department in accordance with the "DoD Financial Management Regulation," the Office of Management and Budget (OMB) Circular No. A-136, "Financial Reporting Requirements," and to the extent possible generally accepted accounting principles (GAAP). The accompanying financial statements account for all resources for which the Department is responsible. Information relative to classified assets, programs, and operations is excluded from the statements or otherwise aggregated and reported in such a manner that it is not discernable.

The Department is unable to fully implement all elements of GAAP and OMB Circular No. A-136 due to limitations of its financial management processes and systems, and non-financial systems and processes that feed into the financial statements. The Department derives its reported values and information for major asset and liability categories largely from non-financial systems, such as inventory systems and logistics systems. These systems were designed to support reporting requirements for maintaining accountability over assets and reporting the status of federal appropriations rather than preparing financial statements in accordance with GAAP. The Department continues to implement process and system improvements addressing these limitations. The Department currently has 11 previously identified auditor material weaknesses: (1) Financial Management Systems, (2) Intragovernmental Eliminations, (3) Unsupported Accounting Entries, (4) Fund Balance with Treasury, (5) Environmental Liabilities, (6) General Property, Plant and Equipment, (7) Government Property and Material in Possession of Contractors, (8) Inventory, (9) Operating Materials and Supplies, (10) Statement of Net Cost, and (11) Statement of Financing.

1.B. Mission of the Reporting Entity

The National Security Act of 1947 established the Department of Defense. The Department's mission is to organize, train, and equip armed forces to deter aggression and, if necessary, defeat aggressors against the United States and its allies. Fiscal year (FY) 2006 is the eleventh year that the Department has prepared audited Agency-wide financial statements as required by the Chief Financial Officers (CFO) Act and Government Management Reform Act (GMRA). Auditors are required to audit the financial statements of the following stand-alone reporting entities: (1) Army General Fund, (2) Army Working Capital Fund, (3) Navy General Fund, (4) Navy Working Capital Fund, (5) Air Force General Fund, (6) Air Force Working Capital Fund, (7) Military Retirement Fund, (8) Medicare-Eligible Retiree Health Care Fund, and (9) U.S. Army Corps of Engineers (Civil Works).

The Department requires the Marine Corps General and Working Capital Funds and the following Defense Agencies to prepare internal stand-alone auditable financial statements: 1) Defense Logistics Agency, 2) Defense Finance and Accounting Service, 3) Defense Information Systems Agency, 4) Defense Contract Audit Agency,

5) Defense Commissary Agency, 6) Defense Security Service, 7) Defense Threat Reduction Agency, 8) Defense Advanced Research Projects Agency, 9) Chemical and Biological Defense Program, 10) Missile Defense Agency, 11) Services Medical Activity, 12) TRICARE Management Activity, and 13) U.S. Special Operations Command.

1.C. Appropriations and Funds

The Department receives its appropriations and funds as general, working capital (revolving), trust, special, and deposit funds. The Components use these appropriations and funds to execute their missions and report on resource usage.

General funds are used for financial transactions funded by congressional appropriations, including personnel, operations and maintenance, research and development, procurement, and military construction accounts.

Working capital funds (WCF) receive their initial funding through an appropriation or a transfer of resources from existing appropriations or funds and use those capital resources to finance the initial startup. The WCF entities provide goods and services on a reimbursable basis. Reimbursable receipts fund ongoing operations and generally are available in their entirety for use without further congressional action.

Trust funds contain receipts and expenditures of funds held in trust by the government for use in carrying out specific purposes or programs in accordance with the terms of the donor, trust agreement, or statute.

Special fund accounts are used to record government receipts reserved for a specific purpose.

Deposit funds are used to record amounts held temporarily until paid to the appropriate government or public entity. The Department is acting as an agent or a custodian for funds awaiting distribution, for example payroll taxes.

Earmarked funds are trust or special funds designated by statute to be used only for specific activities, benefits or purposes. Earmarked funds are financed by specifically identified revenues and remain available over time. Earmarked funds also have a requirement to account for and report on the receipt, use and retention of revenues and other financing sources that distinguish them from general revenues.

1.D. Basis of Accounting

For FY 2006, the Department's financial management systems are unable to meet all of the requirements for full accrual accounting. Many of the Department's financial and non-financial feeder systems and processes were designed and implemented prior to the issuance of GAAP for federal agencies. These systems were not designed to collect and record financial information on the full accrual accounting basis as required by GAAP. Most of the Department's legacy systems were designed to record information on a budgetary basis.

The Department has undertaken efforts to determine the actions required to bring its financial and non-financial feeder systems and processes into compliance with GAAP. One such action is the current revision of its accounting systems to record transactions based on the United States Standard General Ledger (USSGL). Until all

of the Department's financial and non-financial feeder systems and processes are updated to collect and report financial information as required by GAAP, the Department's financial data will be based on budgetary transactions (obligations, disbursements, and collections), transactions from non-financial feeder systems, and adjustments for known accruals of major items such as payroll expenses, accounts payable, and environmental liabilities.

In addition, the Department identifies program costs based upon the major appropriation groups provided by the Congress. Current processes and systems do not capture and report accumulated costs for major programs based upon the performance measures as required by the Government Performance and Results Act (GPRA). The Department is in the process of reviewing available data and attempting to develop a cost reporting methodology that balances the need for cost information required by GPRA and the Statement of Federal Financial Accounting Standard (SFFAS) No. 4, "Managerial Cost Accounting Concepts and Standards for the Federal Government," with the need to keep the financial statements from being overly voluminous.

1.E. Revenues and Other Financing Sources

The Department receives congressional appropriations as financing sources for general funds on either an annual or multi-year basis. When authorized, these appropriations are supplemented by revenues generated by sales of goods or services. The Department recognizes revenue as a result of costs incurred for goods and services provided to other federal agencies and the public. Full cost pricing is the Department's standard policy for services provided as required by OMB Circular No A-25 "Transmittal Memorandum #1, User Charges". The Department recognizes revenue when earned within the constraints of current system capabilities. In some instances, revenue is recognized when bills are issued.

Depot Maintenance and Ordnance WCF activities recognize revenue according to the percentage of completion method. Supply Management WCF activities recognize revenue from the sale of inventory items.

The Department does not include non-monetary support provided by U.S. allies for common defense and mutual security in amounts reported in the Statement of Net Cost and the Statement of Financing. The U.S. has cost-sharing agreements with other countries. Examples include countries where there is a mutual or reciprocal defense agreement, where U.S. troops are stationed, or where the U.S. Fleet is in a port.

1.F. Recognition of Expenses

For financial reporting purposes, the Department's policy requires the recognition of operating expenses in the period incurred. However, because the Department's financial and non-financial feeder systems were not designed to collect and record financial information on the full accrual accounting basis, accrual adjustments are made for major items such as payroll expenses, accounts payable, environmental liabilities, and unbilled revenue. The Department's expenditures for capital and other long-term assets are recognized as operating expenses based on depreciation. In the case of Operating Materials and Supplies (OM&S), operating expenses are generally recognized when the items are purchased. Efforts are underway to migrate towards the consumption method for recognizing OM&S expenses.

1.G. Accounting for Intragovernmental Activities

Preparation of reliable financial statements requires the elimination of transactions occurring among entities within the Department or between two or more federal agencies. However, the Department cannot accurately identify most of its intragovernmental transactions by customer because the Department's systems do not track buyer and seller data needed to match related transactions. Seller entities within the Department provide summary seller-side balances for revenue, accounts receivable, and unearned revenue to the buyer-side internal Department accounting offices. In most cases, the buyer-side records are adjusted to agree with Department seller-side balances. Intra-Department intragovernmental balances are then eliminated. The Department is developing long-term systems improvements that will include sufficient up-front edits and controls to eliminate the need for after-the-fact reconciliations. The volume of intragovernmental transactions is so large that an after-the-fact reconciliation cannot be accomplished effectively with existing or foreseeable resources.

The Department of the Treasury Financial Management Service is responsible for eliminating transactions between the Department and other federal agencies. The Treasury Financial Manual Part 2 – Chapter 4700, "Agency Reporting Requirements for the Financial Report of the United States Government," and the Treasury's "Federal Intragovernmental Transactions Accounting Policies Guide," provide guidance for reporting and reconciling intragovernmental balances. While the Department is unable to fully reconcile intragovernmental transactions with all federal partners, the Department is able to reconcile balances pertaining to investments in federal securities, borrowings from the U.S. Treasury and the Federal Financing Bank, Federal Employees' Compensation Act transactions with the Department of Labor (DOL), and benefit program transactions with the Office of Personnel Management (OPM). The Department's proportionate share of public debt and related expenses of the federal government are not included. The federal government does not apportion debt and its related costs to federal agencies. The Department's financial statements, therefore, do not report any portion of public debt or interest thereon, nor do the statements report the source of public financing whether from issuance of debt or tax revenues.

Financing for the construction of Department facilities is obtained through appropriations. To the extent this financing ultimately may have been obtained through the issuance of public debt, interest costs have not been capitalized since the Department of the Treasury does not allocate such interest costs to the benefiting agencies.

1.H. Transactions with Foreign Governments and International Organizations

Each year, the Department sells defense articles and services to foreign governments and international organizations under the provisions of the "Arms Export Control Act of 1976." The provisions of the Act authorize the Department to sell defense articles and services to foreign countries and international organizations, generally at no profit or loss to the U.S. Government. Payment is required in advance.

1.I. Funds with the U.S. Treasury

The Department's monetary financial resources are maintained in U.S. Treasury accounts. The disbursing offices of the Defense Finance and Accounting Service (DFAS), the Military Services, the U.S. Army Corps of Engineers (USACE), and the Department of State's financial service centers process the majority of the Department's cash

collections, disbursements, and adjustments worldwide. Each disbursing station prepares monthly reports that provide information to the U.S. Treasury on check issues, electronic fund transfers, and interagency transfers, and deposits.

In addition, the DFAS sites and the USACE Finance Center submit reports to the Department of the Treasury, by appropriation, on interagency transfers, collections received, and disbursements issued. The Department of the Treasury records this information to the applicable Fund Balance with Treasury (FBWT) account. Differences between the Department's recorded balance in the FBWT accounts and Treasury's FBWT accounts are reconciled.

1.J. Foreign Currency

Cash is the total of cash resources under the control of the Department, which includes coin, paper currency, negotiable instruments, and amounts held for deposit in banks and other financial institutions. Foreign currency consists of the total U.S. dollar equivalent of both purchased and non-purchased foreign currencies held in foreign currency fund accounts.

The majority of cash and all foreign currency is classified as nonentity and, therefore, restricted. Amounts reported consist primarily of cash and foreign currency held by Disbursing Officers to carry out their paying, collecting, and foreign currency accommodation exchange missions. Cash seized during Operation Iraqi Freedom is restricted for use to assist the Iraqi people and support the restoration of Iraq.

The Department conducts a significant portion of its operations overseas. The Congress established a special account to capture the gains and losses from foreign currency transactions for five general fund appropriations (operations and maintenance, military personnel, military construction, family housing operations and maintenance, and family housing construction). The gains and losses are computed as the variance between the exchange rate at the date of payment and a budget rate established at the beginning of each fiscal year. Foreign currency fluctuations related to other appropriations require adjustments to the original obligation amount at the time of payment. The Department does not separately identify currency fluctuations.

1.K. Accounts Receivable

As presented in the Balance Sheet, accounts receivable includes accounts, claims, and refunds receivable from other federal entities or from the public. Allowances for uncollectible accounts due from the public are based upon analysis of collection experience by fund type. The Department does not recognize an allowance for estimated uncollectible amounts from other federal agencies. Claims against other federal agencies are to be resolved between the agencies (per the Code of Federal Regulations 4 CFR 101).

The Department bases the estimate of uncollectible accounts receivable from the public as either a percentage of actual prior-year write-offs or a percentage of aged accounts receivable from the public.

1.L. Direct Loans and Loan Guarantees

The Department operates a direct loan and loan guarantee program authorized by the National Defense Authorization Act for FY 1996, Public Law 104-106, Stat 186, Section 2801. The Act includes a series of authorities that allow the Department to work with the private sector to renovate military housing. The Department's goals are to obtain private capital to leverage government dollars, make efficient use of limited resources, and use a variety of private sector approaches to build and renovate military housing faster and at a lower cost to American taxpayers.

The Act also provides the Department with a variety of authorities to obtain private sector financing and expertise to improve military housing. The Department uses these authorities individually or in combination. They include guarantees (both loan and rental); conveyance/leasing of existing property and facilities; differential lease payments; investments (both limited partnerships and stock/bond ownership); and direct loans. In addition, the "Federal Credit Reform Act of 1990" governs all amended direct loan obligations and loan guarantee commitments made after FY 1991 resulting in direct loans or loan guarantees.

The Department also operates a loan guarantee program designed to encourage commercial use of inactive government facilities. The revenue generated from property rental offsets the cost of maintaining these facilities.

The National Defense Authorization Act for FY 2005, Public Law 108-375, Section 2805, provided permanent authorities to the Military Housing Privatization Initiative.

1.M. Inventories and Related Property

The Department values approximately 60 percent of resale inventory using the moving average cost method. An additional 2 percent (fuel inventory) is reported using the first-in-first-out method. The Department reports the remaining 38 percent of resale inventories at an approximation of historical cost using latest acquisition cost adjusted for holding gains and losses. The latest acquisition cost method is used because legacy inventory systems were designed for materiel management rather than accrual accounting. Although these systems provide visibility and accountability over inventory items, they do not maintain historical cost data necessary to comply with SFFAS No. 3, "Accounting for Inventory and Related Property." Additionally, these systems cannot produce financial transactions using the USSGL, as required by the Federal Financial Management Improvement Act of 1996 (P.L. 104-208). By utilizing new systems development processes, Department Components are continuing to transition the balance of their inventories to the moving average cost method. However, since the on-hand balances which transitioned were not, for the most part, baselined to auditable historical cost, the reported values remain non-compliant with SFFAS No. 3 and GAAP.

The Department manages only military or government-specific materiel under normal conditions. Items commonly used in and available from the commercial sector are not managed in the Department's materiel management activities. Operational cycles are irregular, and the military risks associated with stock-out positions have no commercial parallel. The Department holds materiel based on military need and support for contingencies. Therefore, the Department does not attempt to account separately for "inventory held for sale" and "inventory held in reserve for future sale" based on SFFAS No. 3 definitions.

Related property includes operating materials and supplies (OM&S) and stockpile materials. The OM&S, including

munitions not held for sale, are valued at standard purchase price. The Department uses both the consumption method and the purchase method of accounting for OM&S. Items that are centrally managed and stored, such as ammunition and engines, are generally recorded using the consumption method and reported on the Balance Sheet as OM&S. When current systems cannot fully support the consumption method, the Department uses the purchase method. Under this method materials and supplies are expensed when purchased. During FY 2006, the Department expensed significant amounts using the purchase method either because the systems could not support the consumption method or because management deemed that the item was in the hands of the end user.

The Department determined that the recurring high dollar value of OM&S in need of repair is material to the financial statements and requires a separate reporting category. Many high-dollar managed items, such as aircraft engines, are categorized as OM&S rather than military equipment.

The Department recognizes condemned materiel as "Excess, Obsolete, and Unserviceable." The cost of disposal is greater than the potential scrap value; therefore, the net value of condemned materiel is zero. Potentially redistributed materiel, presented in previous years as "Excess, Obsolete, and Unserviceable," is included in "Held for Use" or "Held for Repair" categories according to its condition.

Past audits identified uncertainties about the completeness and existence of the reported values of inventory. Inventory available and purchased for resale includes consumable spare and repair parts and repairable items owned and managed by the Department. This inventory is retained to support military or national contingencies. Inventory held for repair is damaged inventory that requires repair to make suitable for sale. It is more economical to repair than to procure these inventory items. Because the Department often relies on weapon systems and machinery no longer in production, the Department supports a process that encourages the repair and rebuilding of certain items. This repair cycle is essential to maintaining a ready, mobile, and armed military force. Finally, work in process balances include costs related to the production or servicing of items, including direct material, direct labor, applied overhead and other direct costs. Work in process balances include costs related to the production or servicing of items, including direct material, direct labor, applied overhead and other direct cost. Work in process also includes the value of finished products or completed services pending the submission of bills to the customer. The work in process designation may also be used to accumulate amounts paid to contractors under cost reimbursable contracts, including amounts withheld from payment to ensure performance, and amounts paid to other government plants for accrued costs of end items of material ordered but not delivered. Work in process includes munitions in production and depot maintenance work with its associated labor, applied overhead, and supplies used in the delivery of maintenance services.

1.N. Investments

The Department reports investments in U.S. Treasury securities at cost, net of amortized premiums or discounts. Premiums or discounts amortize into interest income over the term of the investment using the effective interest rate method or another method obtaining similar results. The Department's intent is to hold investments to maturity, unless they are needed to finance claims or otherwise sustain operations. Consequently, a provision is not made for unrealized gains or losses on these securities.

The Department invests in nonmarketable securities. The two types of nonmarketable securities are par value

and market-based intragovernmental securities. The Bureau of Public Debt issues nonmarketable par value intragovernmental securities. Nonmarketable, market-based intragovernmental securities mimic marketable securities, but are not publicly traded.

The Department's Net Investments are held by various trust and special funds. These funds are comprised of the Military Retirement Trust Fund (MRF); Medicare-Eligible Retiree Health Care Fund (MERHCF); Other Defense Organizations General Fund (ODO GF) trust and special funds; donations (Gift Funds); and the USACE South Dakota Terrestrial Habitat Restoration, Inland Waterways, and Harbor Maintenance Trust Fund accounts.

Other investments represent limited partnerships, entered into on behalf of the U.S. Government in support of the Military Housing Privatization Initiative authorized by Public Law 104-106 Section 2801. These investments do not require market value disclosure.

1.O. General Property, Plant and Equipment

The Department is moving away from a standard capitalization threshold for all categories (e.g. real property, military equipment, etc.) of General Property, Plant, and Equipment (PP&E) to one that is specific for each individual category.

In FY 2006 the capitalization threshold was revised from $100,000 to $20,000 for real property. The current $100,000 capitalization threshold remains unchanged for the remaining General PP&E categories.

General PP&E assets are capitalized at historical acquisition cost plus capitalized improvements when an asset has a useful life of two or more years, and when the acquisition cost equals or exceeds the Department's capitalization threshold of $100,000, except for the USACE and WCF as discussed below. The Department also requires capitalization of improvement costs over the Department's capitalization threshold of $100,000 for General PP&E. The Department depreciates all General PP&E, other than land, on a straight-line basis.

Prior to FY 1996, General PP&E was capitalized if it had an acquisition cost of $15,000, $25,000, and $50,000 for FYs 1993, 1994, and 1995, respectively, and an estimated useful life of two or more years. General PP&E previously capitalized at amounts below $100,000 were written off General Fund financial statements in FY 1998. No adjustment was made for WCF assets. These assets remain capitalized and reported on WCF financial statements.

The USACE Civil Works General PP&E assets are capitalized at historical acquisition cost plus capitalized improvements when an asset has a useful life of two or more years, and when the acquisition cost exceeds $25,000. One exception is all buildings and structures related to hydropower projects, which are capitalized regardless of cost. During FY 2003, the Corps increased its buildings and structures threshold from $0 to $25,000 for all Civil Works appropriations with the exception of Revolving Fund and Power Marketing Agency assets. All Civil Works buildings and structures currently capitalized under $25,000 (excluding Revolving Fund and Power Marketing Agency) were expensed in FY 2003 and removed from the Corps of Engineers Financial Management System. Beginning in FY 2004, all Civil Works Buildings and Structures under $25,000 are expensed except for

Power Marketing Agency assets.

When it is in the best interest of the government, the Department provides government property necessary to contractors to complete contract work. The Department either owns or leases such property, or it is purchased directly by the contractor for the government based on contract terms. When the value of contractor-procured General PP&E exceeds the Department's capitalization threshold, it must be reported on the Department's Balance Sheet.

The Department is developing new policies and a contractor reporting process that will provide appropriate General PP&E information for future financial statement reporting purposes. Accordingly, the Department reports only the government property in the possession of contractors that is maintained in the Department's property systems. The Department has issued property accountability and reporting regulations that require components to maintain, in their property systems, information on all property furnished to contractors. This action and other proposed actions are structured to capture and report the information necessary for compliance with federal accounting standards.

The SFFAS No. 23, "Eliminating the Category National Defense Property, Plant, and Equipment," establishes generally accepted accounting principles for valuing and reporting military equipment (e.g., ships, aircraft, combat vehicles, weapons) in federal financial statements. The standard provides for the use of estimated historical cost for valuing military equipment if obtaining actual historical cost information is not practical. The Department estimated historical costs using the Bureau of Economic Analysis (BEA) estimates to calculate the value of the military equipment for reporting periods from October 1, 2002 through March 31, 2006.

Effective with 3rd Quarter FY 2006, the Department replaced the BEA estimation methodology with an estimation methodology for military equipment based on internal Departmental records. The Department initially identified the universe of military equipment by accumulating information relating to program funding and associated military equipment, equipment useful life, program acquisitions and disposals to create a baseline. The military equipment baseline is updated using expenditure information, and information related to acquisition and logistics to identify acquisitions and disposals.

1.P. Advances and Prepayments

The Department records payments in advance of the receipt of goods and services as advances or prepayments and reports them as assets on the Balance Sheet. The Department recognizes advances and prepayments as expenses when it receives the related goods and services.

1.Q. Leases

Lease payments for the rental of equipment and operating facilities are classified as either capital or operating leases. An operating lease does not substantially transfer all the benefits and risk of ownership. Payments for operating leases are charged to expense over the lease term as it becomes payable.
Capital leases convey certain benefits and risks of ownership, and therefore require recognition of an asset and

corresponding lease liability equal to the present value of the rental and other lease payments during the lease term (excluding portions representing executory costs paid to the lessor) or the asset's fair market value. The discount rate for the present value calculation is either the lessor's implicit interest rate or the government's incremental borrowing rate at the inception of the lease. The Department as the lessee receives the use and possession of leased property, for example real estate or equipment, from a lessor in exchange for a payment of funds.

Office space and leases entered into by the Department in support of contingency operations are the largest components of operating leases. These costs were gathered from existing leases, General Services Administration (GSA) bills, and Inter-service Support Agreements. Future year projections use the Consumer Price Index (CPI), rather than the Department's inflation factor. The CPI impacts increases to the leases, especially those at commercial lease sites. Equipment leases have a variety of lease terms, which are not expected to be renewed upon expiration. Other operating leases are generally one-year leases. The Department expects to continue to reduce the level of owned assets while increasing the number of leased assets. The Department will strive to displace commercial leases with more economical GSA leases.

1.R. Other Assets

Other assets include those assets, such as military and civil service employee pay advances, travel advances, and contract financing payments, that are not reported elsewhere on the Department's Balance Sheet.

Contract financing payments are defined in the Federal Acquisition Regulation (FAR), Part 32, as authorized disbursements of monies to a contractor prior to acceptance of supplies or services by the government. These payments are designed to alleviate the potential financial burden on contractors performing certain long-term contracts and facilitate competition for defense contracts. Contract financing payments clauses are incorporated in the contract terms and conditions and may include advance payments, performance-based payments, commercial advance and interim payments, progress payments based on cost, and interim payments under certain cost-reimbursement contracts.

Contract financing payments do not include invoice payments, payments for partial deliveries, lease and rental payments, or progress payments based on a percentage or stage of completion, which the Defense Federal Acquisition Regulation Supplement (DFARS) authorizes only for construction of real property, shipbuilding, and ship conversion, alteration, or repair. Progress payments for real property and ships are reported as Construction in Progress in Note 10.

1.S. Contingencies and Other Liabilities

The SFFAS No. 5, "Accounting for Liabilities of the Federal Government," as amended by SFFAS No. 12, "Recognition of Contingent Liabilities Arising from Litigation," defines a contingency as an existing condition, situation, or set of circumstances that involves an uncertainty as to possible gain or loss. The uncertainty will be resolved when one or more future events occur or fail to occur. The Department recognizes contingencies as liabilities when past events or exchange transactions occur, a future loss is probable, and the loss amount can be reasonably estimated.

Financial statement reporting is limited to disclosure when conditions for liability recognition do not exist but

there is at least a reasonable possibility of incurring a loss or additional losses. Examples of loss contingencies include the collectibility of receivables, pending or threatened litigation, and possible claims and assessments. The Department's loss contingencies arise as a result of pending or threatened litigation or claims; and assessments occur due to events such as aircraft, ship and vehicle accidents, medical malpractice, property or environmental damages, and contract disputes.

Other liabilities arise as a result of anticipated disposal costs for the Department's assets. This type of liability has two components: nonenvironmental and environmental. Consistent with SFFAS No. 6, "Accounting for Property, Plant, and Equipment," recognition of an anticipated environmental disposal liability begins when the asset is placed into service. Nonenvironmental disposal liabilities are recognized for assets when management decides to dispose of an asset based upon the Department's policy, which is consistent with SFFAS No. 5, "Accounting for Liabilities of the Federal Government." The Department recognizes nonenvironmental disposal liabilities for nuclear-powered military equipment when placed into service. Such amounts are developed in conjunction with, and not easily separately identifiable from, environmental disposal costs.

1.T. Accrued Leave

The Department reports earned military and civilian leave, except sick leave, as accrued liabilities. Sick leave is expensed when taken. The liability reported at the end of the accounting period reflects the current pay rates.

1.U. Net Position

Net position consists of unexpended appropriations and cumulative results of operations.

Unexpended Appropriations represent amounts of authority that are unobligated and have not been rescinded or withdrawn. Unexpended appropriations also represent amounts obligated for which legal liabilities for payments have not been incurred.

Cumulative Results of Operations represent the difference, since inception of an activity, between expenses and losses and financing sources (including appropriations, revenue, and gains). Beginning with FY 1998, these results included the cumulative amount of donations and transfers of assets in and out without reimbursement.

1.V. Treaties for Use of Foreign Bases

The Department has the use of land, buildings, and other overseas facilities that are obtained through various international treaties and agreements negotiated by the Department of State. The Department purchases capital assets overseas with appropriated funds; however, the host country retains title to land and improvements. Generally, treaty terms allow the Department continued use of these properties until the treaties expire. In the event treaties or other agreements are terminated, whereby use of the foreign bases is prohibited, losses are recorded for the value of any nonretrievable capital assets. This takes place after negotiations between the U.S. and the host country have determined the amount to be paid to the U.S. for such capital investments.

1.W. Comparative Data

Financial statement fluctuations greater than two percent of total assets on the Balance Sheet or ten percent from the prior period presented are generally explained within the notes to the financial statements.

1.X. Unexpended Obligation

The Department obligates funds to provide goods and services for outstanding orders not yet delivered. The financial statements do not reflect this liability for payment for goods and services not yet delivered.

1.Y. Undistributed Disbursements and Collection

Undistributed disbursements and collections represent the difference between disbursements and collections matched at the transaction level to a specific obligation, payable, or receivable in the activity field records as opposed to those reported by the U.S. Treasury. These amounts should agree with the undistributed amounts reported on the departmental accounting reports. Intransit payments are those payments that have been made to other agencies or entities that have not been recorded in their accounting records. These payments are applied to the entities' outstanding accounts payable balance. Intransit collections are those collections from other agencies or entities that have not been recorded in the accounting records. These collections are also applied to the entities' accounts receivable balance.

The Department's policy is to allocate supported undistributed disbursements and collections between federal and nonfederal categories based on the percentage of federal and nonfederal accounts payable and accounts receivable. The majority of the Department's components follow this allocation procedure. Unsupported undistributed disbursements are recorded in accounts payable. Unsupported undistributed collections are recorded in other liabilities.

Note 2. Nonentity Assets

As of September 30	2006	2005
(amount in millions)		
Intragovernmental Assets		
Fund Balance with Treasury	$ 2,896.6	$ 1,653.5
Accounts Receivable	11.6	0.3
Total Intragovernmental Assets	2,908.2	1,653.8
Nonfederal Assets		
Cash and Other Monetary Assets	2,085.2	1,959.4
Accounts Receivable	5,486.7	4,469.6
Other Assets	196.8	156.9
Total Nonfederal Assets	7,768.7	6,585.9
Total Nonentity Assets	10,676.9	8,239.7
Total Entity Assets	1,356,376.4	1,257,901.2
Total Assets	$ 1,367,053.3	$ 1,266,140.9

Nonentity assets are assets for which the Department maintains stewardship accountability and has a responsibility to report, but are not available for the Department's operations.

Fluctuations

Nonentity assets increased $2.4 billion (30%) primarily due to an increase of $1.2 billion in nonentity Fund Balance with Treasury and $1.0 billion in Accounts Receivable. The increase in nonentity Fund Balance with Treasury primarily results from the withdrawal of $1.0 billion in Foreign Military Sales funds in FY 2005 with no corresponding withdrawal in FY 2006. The remaining increase in nonentity Accounts Receivable is attributable to Accounts Receivable associated with litigation cases, and the reclassification of assets from entity to nonentity.

Note 3. Fund Balance with Treasury

As of September 30	2006	2005
(amount in millions)		
Fund Balances		
Appropriated Funds	$ 312,055.6	$ 278,565.8
Revolving Funds	9,619.6	8,249.0
Trust Funds	2,212.2	406.2
Special Funds	328.1	344.3
Other Fund Types	2,922.8	3,091.8
Total Fund Balances	327,138.3	290,657.1
Fund Balances Per Treasury Versus Agency		
Fund Balance per Treasury	329,921.4	294,103.0
Fund Balance per Agency	327,138.3	290,657.1
Reconciling Amount	$ 2,783.1	$ 3,445.9

Fluctuations

Fund Balance with Treasury increased $36.5 billion (13%) primarily due to an increase of $32.0 billion in appropriations for critical mission related efforts such as procurement of military equipment, the Global War on Terror, Base Realignment and Closure, and hurricane relief in the Gulf Coast region during FY 2006.

Other Disclosures

The Department shows a reconciling net difference of $2.8 billion with the Department of the Treasury, which is comprised of:

- $3.4 billion of canceling year authority recorded by Treasury, but not reported by the Department.
- $(1.2) billion of Foreign Military Sales (FMS) advances from foreign customers based on future requirement forecast recorded by the Department, but not reported by the Treasury as Department funds.
- $369.0 million of unavailable receipts recorded by Treasury, but not reported by the Department.
- $115.8 million of transfer funds with the Executive Office of the President, the Department of Transportation (DOT), and the U.S Department of Agriculture (USDA) recorded by Treasury, but not reported by the Department.
- $120.5 million in additional availability of funds due to invalid program years recorded by Treasury, but not reported by the Department.
- $(64.9) million of transfer funds with the DOT and the USDA recorded by the Department, but not reported by the Treasury as Department funds.

Status of Fund Balance with Treasury		
As of September 30	2006	2005
(amount in millions)		
Unobligated Balance		
Available	$ 75,401.0	$ 59,934.1
Unavailable	302,033.4	8,690.4
Obligated Balance not yet Disbursed	318,907.6	556,162.3
Nonbudgetary FBWT	7,640.4	8,783.4
NonFBWT Budgetary Accounts	(376,844.1)	(342,387.7)
Total	$ 327,138.3	$ 291,182.5

The Status of Fund Balance with Treasury (FBWT) consists of unobligated and obligated balances. These balances reflect the budgetary authority remaining for disbursements against current or future obligations. In addition, the balances include various accounts that affect either budgetary reporting or FBWT, but not both.

Unobligated Balance represents the cumulative amount of budgetary authority that has not been set aside to cover outstanding obligations. Unobligated Balance is classified as available or unavailable and is associated with appropriations expiring at fiscal year end that remain available only for obligation adjustments until the account is closed. Certain unobligated balances may be restricted for future use and are not apportioned for current use. These balances are only available for investing in nonmarketable market-based securities purchased through Treasury.

Obligated Balance not yet Disbursed represents funds that have been obligated for goods that have not been received or services that have not been performed.

Nonbudgetary FBWT includes entity and nonentity FBWT accounts which do not have budgetary authority, such as unavailable receipt accounts or clearing accounts.

NonFBWT Budgetary Accounts include budgetary accounts that do not affect FBWT, such as contract authority, borrowing authority, and investment accounts. This category reduces the Status of FBWT.

The status of fund balance with Treasury disagrees with the FBWT by $525.4 million for FY 2005 due to an error, which was corrected for FY 2006.

Fluctuations

Total Status of FBWT increased $36.0 billion (13%). Unobligated Balance Unavailable increased $293.3 billion and Obligated Balance not yet Disbursed decreased $237.3 billion due to the reclassification of certain special and trust fund balances in FY 2006. This reclassification brings the Department into compliance with the Office of Management and Budget Circular No. A-136, "Financial Reporting Requirements," and permits better reconciliation of FBWT to the President's Budget.

Disclosures Related to Suspense/Budget Clearing Accounts				
As of September 30	2004	2005	2006	(Decrease)/ Increase from FY2005 - 2006
(amount in millions)				
Account				
F3845 – Personal Property Proceeds	$ 0.0	$ 0.9	$ 0.7	$ (0.2)
F3875 – Disbursing Officer Suspense	(608.5)	263.5	903.9	640.4
F3880 – Lost or Cancelled Treasury Checks	(1.4)	11.9	26.4	14.5
F3882 – Uniformed Services Thrift Savings Plan Suspense	(59.5)	83.5	108.5	25.0
F3885 – Interfund/IPAC Suspense	(118.2)	(211.6)	(114.9)	96.7
F3886 – Thrift Savings Plan Suspense	0.2	(4.9)	(6.4)	(1.5)
Total	$ (787.4)	$ 143.3	$ 918.2	$ 774.9

The F3845 suspense account represents the balance of proceeds from the sale of personal property.

The F3875, F3885, and the F3886 suspense clearing accounts temporarily hold collections or disbursements until they can be assigned or identified to a valid appropriation. The F3875 suspense clearing account represents the Disbursing Officer's suspense. Account F3885 represents the Interfund and Intragovernmental Payment and Collection (IPAC) suspense. Account F3886 represents payroll deductions for the Thrift Savings Plan (TSP) suspense.

The F3880 suspense account represents the balance of Treasury checks that (1) have either been lost by the payee and need to be reissued, (2) have never been cashed by the payee, or (3) have been cancelled by the Treasury and need to be transferred to the original appropriation.

The F3882 suspense account was established for the Uniformed Services TSP in FY 2002. The amounts in this account represent a timing difference between the posting of the TSP deductions by the USDA National Finance Center and the posting of these amounts in the military accounting systems in the following month.

Fluctuations

Total suspense accounts increased $774.9 million. This increase is primarily attributable to the $640.4 million increase in Disbursing Officer suspense caused by timing differences in disbursements of military and civilian payroll in the 4th Quarter, FY 2006. In 4th Quarter, FY 2006, these accounts included individual income and Federal Insurance Contributions Act tax withholdings, whereas, 4th Quarter, FY 2005 payroll tax withholdings were disbursed prior to the end of the accounting period.

Other Disclosures

The total amount reported above for FY 2005 does not agree with balances reported last year-end due to the inclusion of the Personal Property Proceeds account in the current year schedule. The note schedule did not include this account for 4th Quarter, FY 2005.

Disclosures Related to Problem Disbursements and In-Transit Disbursements				
As of September 30	2004	2005	2006	(Decrease)/ Increase from FY2005 - 2006
(amount in millions)				
Total Problem Disbursements, Absolute Value				
Unmatched Disbursements (UMDs)	$ 817.7	$ 2,198.6	$ 3,345.4	$ 1,146.8
Negative Unliquidated Obligations (NULO)	88.8	89.1	78.6	(10.5)
Total In-transit Disbursements, Net	$ 4,197.0	$ 4,130.8	$ 4,588.8	$ 458.0

An unmatched disbursement (UMD) occurs when a payment is not matched to a corresponding obligation in the accounting system. Absolute value is the sum of the positive values of debit and credit transactions without regard to the sign (plus or minus).

A negative unliquidated obligation (NULO) occurs when a payment is made against a valid obligation, but the payment is greater than the amount of the obligation recorded in the official accounting system. These payments have been made using available funds and are based on valid receiving reports for goods and services delivered under valid contracts.

The In-transits represent the net value of disbursements and collections made by the Department disbursing activity on behalf of an accountable activity and have not been posted to the accounting system.

Fluctuations

The Department reported a $1.1 billion increase (52%) in UMDs. This fluctuation is primarily attributable to systemic problems, insufficient documentation, erroneous data, and input errors.

The Department reported a $10.5 million decrease (12%) in NULOs. This decrease consists of $7.4 million due to more timely receipt of supporting documentation.

The Department reported an increase in In-transits of $458 million (11%) primarily attributable to $799.5 million in Mechanization of Contract Administration Services files for payments that were not posted by the Department as of 4th Quarter, FY 2006. This increase was partially offset by a $472.9 million decrease in an effort to identify systemic errors and implement corrective actions to validate data throughout FY 2006.

Other Disclosures

The amounts reported in FY 2004 and FY 2005 have been changed to reflect correct balances reported in the prior year problem disbursements and in-transits. Due to timing issues in receipt of expenditure information in prior years, the Department corrected prior year balances to better reflect year-end reporting.

Note 4. Investments and Related Interest

As of September 30	2006								
(amount in millions)	Cost		Amortization Method	Amortized (Premium) / Discount		Investments, Net		Market Value Disclosure	
Intragovernmental Securities									
Nonmarketable, Market-Based	$	304,523.2	Effective Interest	$	(9,105.6)	$	295,417.6	$	291,259.5
Accrued Interest		3,843.6					3,843.6		3,843.6
Total Intragovernmental Securities		308,366.8			(9,105.6)		299,261.2		295,103.1
Total Other Investments	$	1,089.8		$	0.0	$	1,089.8		N/A

As of September 30	2005								
(amount in millions)	Cost		Amortization Method	Amortized (Premium) / Discount		Investments, Net		Market Value Disclosure	
Intragovernmental Securities									
Nonmarketable, Market-Based	$	273,976.0	Effective Interest	$	(14,551.2)	$	259,424.8	$	262,243.7
Accrued Interest		3,943.0					3,943.0		3,943.0
Total Intragovernmental Securities	$	277,919.0		$	(14,551.2)	$	263,367.8	$	266,186.7
Total Other Investments	$	605.0		$	0.0	$	605.0		N/A

Fluctuations

Intragovernmental Securities

Total Intragovernmental Securities, Net Investments increased $35.9 billion (14%). The increase was primarily due to increased cash flow made available for investing. The Medicare-Eligible Retiree Health Care Fund investments increased $24.7 billion because of contributions (in excess of beneficiary payments) from the Treasury, the Military Services and other Uniformed Services (U.S. Coast Guard, U.S. Public Health Service, and the National Oceanic Atmospheric Administration) plus accrued interest earned. The Military Retirement Fund investments increased $10.6 billion because of contributions (in excess of beneficiary payments) from Treasury and the Military Services, the maturation of U.S. Treasury notes and bills that were reinvested in overnight Treasury securities yielding a higher interest rate, and accrued interest earned.

Other Investments

Other Investments (with the Public) increased $484.8 million (80%) from new investments in limited partnerships in support of military housing.

Other Disclosures

The Federal Government does not set aside assets to pay future benefits or other expenditures associated with earmarked funds. The cash receipts collected from the public for an earmarked fund are deposited in the Treasury, which uses the cash for general Government purposes. Treasury securities are issued to the Department as evidence of its receipts. Treasury securities are an asset to the Department and a liability to the Treasury. Because the Department and the Treasury are both parts of the Government, these assets and liabilities offset each other from the standpoint of the Government as a whole. For this reason, receipts do not represent an asset or a liability in the U.S. Governmentwide financial statements. Treasury securities provide the Department with authority to draw upon the Treasury to make future benefit payments or other expenditures. When the Department requires redemption of these securities to make the expenditures, the Government finances those expenditures out of accumulated cash balances, by raising taxes or other receipts, by borrowing from the public or repaying less debt, or by curtailing other expenditures. This is the same way that the Government finances all other expenditures.

Note 5. Accounts Receivable

As of September 30	2006			2005
(amounts in millions)	Gross Amount Due	Allowance For Estimated Uncollectibles	Accounts Receivable, Net	Accounts Receivable, Net
Intragovernmental Receivables	$ 2,927.4	N/A	$ 2,927.4	$ 1,291.3
Nonfederal Receivables (From the Public)	8,214.5	(350.4)	7,864.1	7,615.5
Total Accounts Receivable	$ 11,141.9	$ (350.4)	$ 10,791.5	$ 8,906.8

Intragovernmental accounts receivables increased $1.6 billion primarily due to the direct support provided to the Federal Emergency Management Agency for hurricane relief efforts in the Gulf Coast.

Aged Accounts Receivable				
As of September 30	2006		2005	
	Intragovernmental	Nonfederal	Intragovernmental	Nonfederal
(amounts in millions)				
Category				
Nondelinquent				
Current	$ 7,735.6	$ 1,840.8	$ 8,446.6	$ 2,242.5
Noncurrent	232.1	1,740.9	341.3	1,713.1
Delinquent				
1 to 30 days	321.1	159.9	221.3	110.3
31 to 60 days	345.7	53.4	23.5	63.3
61 to 90 days	57.2	117.8	95.4	77.2
91 to 180 days	716.5	130.0	100.9	185.3
181 days to 1 year	908.7	207.2	134.2	255.9
Greater than 1 year and less than or equal to 2 years	44.4	192.2	107.6	833.9
Greater than 2 years and less than or equal to 6 years	55.0	896.2	100.4	152.8
Greater than 6 years and less than or equal to 10 years	1.2	676.0	9.2	284.1
Greater than 10 years	0.0	2,640.5	0.0	2,557.8
Subtotal	$ 10,417.5	$ 8,654.9	$ 9,580.4	$ 8,476.2
Less Supported Undistributed Collections	(492.7)	(478.9)	(587.6)	(451.8)
Less Eliminations	(6,986.3)	0.0	(7,647.1)	0.0
Less Other	(11.1)	38.5	(54.4)	(33.7)
Total	$ 2,927.4	$ 8,214.5	$ 1,291.3	$ 7,990.7

Nondelinquent noncurrent accounts receivable total $1.9 billion for 4th Quarter, FY 2006 and represent those amounts that are due beyond the next 12 months. These accounts are not considered delinquent since the associated repayment schedules allow for repayment after a 30-day period and are not yet due under the contract or billing documents pertaining to the receivable.

The Less Other line item above consists primarily of adjustments posted after closure of the accounting records. These include (1) adjustments to supported undistributed collections, (2) reclassifications between intragovernmental and nonfederal as part of the Department of Defense trading partner process that were not included on the elimination line, and (3) any discrepancies between the subsidiary detail transactions and the trial balance.

The Department utilizes several different programs (Treasury Offset Program, Vendor Pay Offset Program, Central Debt System, Intragovernmental Payment and Collection, Defense Cash Accountability System, Delinquent Debt

Management System, Salary Offset Program, and Private Collection Services) to pursue collection action on delinquent and nondelinquent accounts receivable in accordance with Office of Management and Budget Circular A-129, "Policies for Federal Credit Programs and Non-Tax Receivables." In certain instances, the status of litigation impacts the Department's ability to pursue collection actions.

The Department is working with the Federal Emergency Management Agency (FEMA) to reduce the intragovernmental accounts receivable balances. The Department implemented a modified Intragovernmental Payment and Collection agreement with FEMA which has accelerated collections. In addition, FEMA agreed to make partial payments for the portion of a bill that can be supported. The Department has also implemented procedures to monitor the turnaround time for providing billing information to FEMA to avoid unnecessary delays in receiving payment. During 4th quarter, the Department reduced its delinquent FEMA receivables by $552.0 million.

Note 6. Other Assets

As of September 30	2006	2005 Restated
(amounts in millions)		
Intragovernmental Other Assets		
Advances and Prepayments	$ 1,064.7	$ 1,394.2
Other Assets	124.9	124.9
Total Intragovernmental Other Assets	1,189.6	1,519.1
Nonfederal Other Assets		
Outstanding Contract Financing Payments	25,630.4	21,776.1
Other Assets (With the Public)	2,298.3	2,046.0
Total Nonfederal Other Assets	27,928.7	23,822.1
Total Other Assets	$ 29,118.3	$ 25,341.2

Fluctuations

Intragovernmental Other Assets

Intragovernmental Other Assets decreased $329.5 million (22%), primarily due to $222.5 million in Department advances returned from the Department of the Interior. These advances were returned as a result of a Department-wide effort to review all Department funds with non-Department federal entities and coordinate the return of funds that had either expired or were no longer available for use.

Nonfederal Other Assets

Nonfederal Other Assets increased $4.1 billion (17%), primarily due to a $3.3 billion increase in estimated future contract financing payments. Beginning 4th Quarter, FY 2006, the Department changed its reporting practices to

recognize estimated future contract financing payments and a contingent liability (additional discussion in Note 15, Other Liabilities), conditional upon the future delivery and Government acceptance of a satisfactory product.

Other Disclosures

Intragovernmental Other Assets include a $124.9 million prior-period adjustment to recognize the Department's right to approximately 6.4 million barrels of crude oil held by the Department of Energy (DOE) on behalf of the Department. The Department provided funds to DOE in FY 1993 to acquire the reserve; however, due to an accounting error, no asset was established. See Note 25 for further disclosures.

Contract terms and conditions for certain types of contract financing payments convey certain rights to the Department that protect the contract work from state or local taxation, liens or attachment by the contractor's creditors, transfer of property, or disposition in bankruptcy; however, these rights should not be misconstrued to mean that ownership of the contractor's work has transferred to the Government. The Government does not have the right to take the work, except as provided in contract clauses related to termination or acceptance, and the Department is not obligated to make payment to the contractor until delivery and acceptance of a satisfactory product.

Other Assets (With the Public) are primarily comprised of advances for military and travel pay, fish and wildlife migration studies performed by the U.S. Army Corps of Engineers, and an advance payment pool agreement with the Massachusetts Institute of Technology and other nonprofit institutions.

Note 7. Cash and Other Monetary Assets

As of September 30	2006	2005
(amounts in millions)		
Cash	$ 1,389.0	$ 1,494.0
Foreign Currency	810.8	578.7
Total Cash, Foreign Currency, & Other Monetary Assets	$ 2,199.8	$ 2,072.7

Approximately $1.3 billion in cash and $810.8 million in foreign currency are nonentity and their use is restricted.

Note 8. Direct Loan and/or Loan Guarantee Programs

Direct Loan and/or Loan Guarantee Programs

The entity operates the following direct loan and/or loan guarantee program(s):
- Military Housing Privatization Initiative
- Armament Retooling & Manufacturing Support Initiative

The Federal Credit Reform Act of 1990 governs all amended direct loan obligations and loan guarantee commitments made after FY 1991 resulting in direct loans or loan guarantees.

Direct loans are reported at the net present value of the following projected cash flows:
- Loan disbursements;
- Repayments of principal; and
- Payments of interest and other payments over the life of the loan after adjusting for estimated defaults, prepayments, fees, penalties and other recoveries.

Loan guarantee liabilities are reported at the net present value. The cost of the loan guarantee is the net present value of the following estimated projected cash flows:
- Payments by the Department to cover defaults and delinquencies, interest subsidies, or other payments; offset by
- Payments to the Department including origination and other fees, penalties, and recoveries.

Military Housing Privatization Initiative

The Military Housing Privatization Initiative (MHPI) includes both direct loan and loan guarantee programs. The Department obtains private sector capital to leverage government dollars. The Department provides protection against specific risks, such as base closure or member deployment, for the private sector partner. The loan guarantee program is authorized by the National Defense Authorization Act for FY 1996, Public Law 104-106, Section 2801.

Armament Retooling and Manufacturing Support Initiative

The Armament Retooling and Manufacturing Support Initiative (ARMS), Title 10 United States Code 4551-4555, is a loan guarantee program designed to encourage commercial use of the Army's Inactive Ammunition Plants through many incentives for businesses willing to locate to a government ammunition production facility. The production capacity of these facilities is greater than current military requirements; however, this capacity may be needed by the military in the future. The revenues from the property rental are used to pay for the operation, maintenance and environmental cleanup at the facilities. The resulting savings in overhead costs lower the production cost of the goods manufactured and fund environmental cleanup at no cost to the government.

Direct Loans Obligated After FY 1991		
As of September 30	2006	2005
(amounts in millions)		
Loan Programs		
Military Housing Privatization Initiative		
Loans Receivable Gross	$ 296.3	$ 141.5
Allowance for Subsidy Cost (Present Value)	(104.6)	(65.9)
Value of Assets Related to Direct Loans	191.7	75.6
Total Loans Receivable	$ 191.7	$ 75.6

Fluctuations

Total Loans Receivable increased $116.1 million. The increase is due to five new direct loans disbursed in FY 2006 for Wright-Patterson Air Force Base (AFB), Ohio; Elmendorf AFB, Alaska; and Kirtland AFB, New Mexico.

Other Disclosures

Subsidy costs are recognized when direct loans are disbursed to borrowers and are reestimated each year as of the date of the financial statements. The allowance for subsidy cost is the difference between the outstanding principal of the loans and the present value of their net cash flows.

The Department's loans receivable are not the same as the proceeds that it would expect to receive from selling the loans.

Gross direct loans for the MHPI program from inception consist of the following:

FY 2006 Direct Loans	*(Amount in millions)*
Elmendorf AFB, Alaska	$122.5
Kirtland AFB, New Mexico	58.6
Camp Pendleton Marine Corps Base, California	29.4
Dyess AFB, Texas	28.9
Robins AFB, Georgia	22.3
Wright-Patterson AFB, Ohio	21.9
Lackland AFB, Texas	10.2
Kingsville AFB, Texas	2.5
Total Loans Receivable Gross	**$296.3**

Total Amount of Direct Loans Disbursed		
As of September 30	2006	2005
(amounts in millions)		
Direct Loan Programs		
Military Housing Privatization Initiative	$ 155.0	$ 0.0
Total	$ 155.0	$ 0.0

The Department disbursed new direct loans for Wright-Patterson AFB, Ohio ($21.9 million); Kirtland AFB, New Mexico ($58.6 million); and Elmendorf AFB, Alaska ($74.5 million) in FY 2006. The demand for direct loans by private developers varies from year to year depending upon the progress of planned construction and renovation, and upon economic factors unrelated to the operations of the Department.

Subsidy Expense for Post FY 1991 Direct Loan					
As of September 30					
(amounts in millions)					
2006	Interest Differential	Defaults	Fees	Other	Total
New Direct Loans Disbursed:					
Military Housing Privatization Initiative	$ 27.9	$ 20.7	$ 0.0	$ 0.0	$ 48.6
2005	Interest Differential	Defaults	Fees	Other	Total
New Direct Loans Disbursed:					
Military Housing Privatization Initiative	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 0.0
2006	Modifications	Interest Rate Reestimates	Technical Reestimates	Total Reestimates	Total
Direct Loan Modifications and Reestimates:					
Military Housing Privatization Initiative	$ 0.0	$ (0.3)	$ (7.8)	$ (8.1)	$ (8.1)
2005	Modifications	Interest Rate Reestimates	Technical Reestimates	Total Reestimates	Total
Direct Loan Modifications and Reestimates:					
Military Housing Privatization Initiative	$ (0.3)	$ (0.9)	$ (3.6)	$ (4.5)	$ (4.8)
	2006	2005			
Total Direct Loan Subsidy Expense:					
Military Housing Privatization Initiative	$ 40.5	$ (4.8)			

Fluctuations

The total subsidy expense for direct loans is $40.5 million due to interest differential and defaults related to the new loans disbursed for FY 2006 and reestimates on outstanding direct loans.

Subsidy Rate for Direct Loans					
As of September 30	Interest Differential	Defaults	Fees and other Collections	Other	Total
Direct Loan Programs					
Military Housing Privatization Initiative	19.44%	8.95%	0.00%	0.00%	28.39%

Subsidy rates disclosed pertain to the loan agreements contracted during the current fiscal year. These rates cannot be applied to the direct loans disbursed during the current reporting year to yield the subsidy expense. The subsidy expense for new loans disbursed in the current year could result from disbursement of loans from both current and prior-year loan agreements. The subsidy expense reported in the current year also includes modifications and reestimates.

Schedule for Reconciling Subsidy Cost Allowance Balances for Post 1991 Direct Loans		
As of September 30	2006	2005
(amounts in millions)		
Beginning Balance of the Subsidy Cost Allowance	$ 65.9	$ 70.7
Add: Subsidy Expense for Direct Loans Disbursed during the Reporting Years by Component		
Interest Rate Differential Costs	27.9	0.0
Default Costs (Net of Recoveries)	20.7	0.0
Total of the above Subsidy Expense Components	48.6	0.0
Adjustments		
Subsidy Allowance Amortization	(1.8)	(0.3)
Total of the above Adjustment Components	(1.8)	(0.3)
Ending Balance of the Subsidy Cost Allowance before Re-estimates	112.7	70.4
Add or Subtract Subsidy Reestimates by Component		
Interest Rate Reestimate	(0.3)	(0.9)
Technical/Default Reestimate	(7.8)	(3.6)
Total of the above Reestimate Components	(8.1)	(4.5)
Ending Balance of the Subsidy Cost Allowance	$ 104.6	$ 65.9

Defaulted Guaranteed Loans from Post FY 1991 Guarantees

The Department had a defaulted guaranteed loan in FY 1999 in the ARMS Initiative Program that was paid in FY 2006 in the amount of $11.4 million. The third party contractor filed bankruptcy in FY 2000 and dissolved operations. Therefore, the Department is unable to pursue collection from the contractor. The Department borrowed $11.4 million and will pursue appropriate methods of reimbursement to the Treasury.

The Department had a guaranteed loan that defaulted in September 2006. The Department is currently working on issues related to this default.

Guaranteed Loans Outstanding		
As of September 30	Outstanding Principal of Guaranteed Loans, Face Value	Amount of Outstanding Principal Guaranteed
(amounts in millions)		
Guaranteed Loans Outstanding		
Military Housing Privatization Initiative	$ 551.3	$ 551.3
Armament Retooling & Manufacturing Support Initiative	20.5	18.2
Total	$ 571.8	$ 569.5
New Guaranteed Loans Disbursed		
Armament Retooling & Manufacturing Support Initiative	2.7	2.3
Total	$ 2.7	$ 2.3
New Guaranteed Loans Disbursed		
Military Housing Privatization Initiative	$ 165.0	$ 165.0
Armament Retooling & Manufacturing Support Initiative	0.7	0.6
Total	$ 165.7	$ 165.6

The Guaranteed Loans Outstanding for the MHPI program as of the 4th Quarter, FY 2006, consists of the following:

Loan Guarantees	*(Amount in millions)*
Fort Polk, Louisiana	$165.0
Fort Carson, Colorado	144.3
Kirtland AFB, New Mexico	74.0
Wright Patterson AFB, Ohio	65.0
Elmendorf AFB, Alaska	48.0
Lackland AFB, Texas	29.4
Robins AFB, Georgia	25.6
Total	**$551.3**

Liabilities for Post FY 1991 Loan Guarantees, Present Value		
As of September 30	2006	2005
(amounts in millions)		
Loan Guarantee Program(s)		
Military Housing Privatization Initiative	$ 23.8	$ 28.7
Armament Retooling & Manufacturing Support Initiative	13.0	12.4
Total	$ 36.8	$ 41.1

For additional information, see the Schedule for Reconciling Loan Guarantee Liability Balances for Post 1991 Loan Guarantees.

Subsidy Expense for Post FY 1991 Loan Guarantees					
As of September 30					
(amounts in millions)					
2006	Interest Differential	Defaults	Fees	Other	Total
New Loan Guarantees Disbursed:					
Military Housing Privatization Initiative	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 0.0
Armament Retooling & Manufacturing Support Initiative	0.0	0.2	11.6	11.8	11.8
Total	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 0.0
2005	Interest Differential	Defaults	Fees	Other	Total
New Loan Guarantees Disbursed:					
Military Housing Privatization Initiative	$ 0.0	$ 10.3	$ 0.0	$ 0.0	$ 10.3
Total	$ 0.0	$ 10.3	$ 0.0	$ 0.0	$ 10.3
2006	Modifications	Interest Rate Reestimates	Technical Reestimates	Total Reestimates	Total
Modifications and Reestimates:					
Military Housing Privatization Initiative	$ 0.0	$ 0.0	$ (6.4)	$ (6.4)	$ (6.4)
Total	$ 0.0	$ 0.2	$ 5.2	$ 5.4	$ 5.4
2005	Modifications	Interest Rate Reestimates	Technical Reestimates	Total Reestimates	Total
Modifications and Reestimates:					
Military Housing Privatization Initiative	$ 1.1	$ (1.5)	$ (3.4)	$ (4.9)	$ (3.8)
Total	$ 1.1	$ (1.5)	$ (3.4)	$ (4.9)	$ (3.8)

	2006	2005
Total Loan Guarantee:		
Military Housing Privatization Initiative	$ (6.4)	$ 6.5
Armament Retooling & Manufacturing Support Initiative	11.8	0.0
Total	$ 5.4	$ 6.5

The total subsidy expense for guaranteed loans is $5.4 million due to interest rate reestimates and technical reestimates.

Subsidy Rates for Loan Guarantees					
As of September 30	Interest Supplements	Defaults	Fees and other Collections	Other	Total
(amounts in millions)					
Loan Guarantee Programs:					
Military Housing Privatization Initiative	0.00%	9.65%	0.00%	0.00%	9.65%
Armament Retooling & Manufacturing Support Initiative	0.00%	20.00%	0.00%	0.00%	20.00%

The subsidy rates disclosed pertain only to loan agreements contracted during the current fiscal year. These rates cannot be applied to the guarantees of loans disbursed during the current reporting year to yield the subsidy expense. The subsidy expense for new loans reported in the current year result from disbursements of loans from both current year loan agreements and prior year(s) loan agreements. The subsidy expense reported in the current year also includes modifications and reestimates.

Schedule for Reconciling Loan Guarantee Liability Balances for Post FY 1991 Loan Guarantees		
As of September 30	2006	2005
(amounts in millions)		
Beginning Balance of the Loan Guarantee Liability	$ 41.1	$ 34.4
Add: Subsidy Expense for Guaranteed Loans Disbursed during the Reporting Years by Component		
Default Costs (Net of Recoveries)	0.0	10.3
Total of the above Subsidy Expense Components	$ 0.0	$ 10.3
Adjustments		
Fees Received	0.0	0.1
Claim Payments to Lenders	(11.4)	0.0
Interest Accumulation on the Liability Balance	1.7	1.1
Total of the above Adjustments	$ (9.7)	$ 1.2
Ending Balance of the Loan Guarantee Liability before Reestimates	$ 31.4	$ 45.9
Add or Subtract Subsidy Reestimates by Component		
Interest Rate Reestimate	0.2	(1.5)
Technical/default Reestimate	5.2	(3.3)
Total of the above Reestimate Components	$ 5.4	$ (4.8)
Ending Balance of the Loan Guarantee Liability	$ 36.8	$ 41.1

Fluctuations

The Loan Guarantee Liability decreased $4.3 million (11%) primarily due to a loan default for the ARMS Initiative Program. The loan defaulted in August 1999 and was previously in litigation to determine the actual amount of debt owed. This claim of $11.4 million was paid during 2nd Quarter, FY 2006. In addition, the Department had a defaulted loan guarantee in September 2006 which increased the technical reestimate.

Administrative Expenses

Administrative Expense is limited to separately identified expenses administered to direct and guaranteed loans. The Department does not maintain a separate program to capture the expenses related to direct and guaranteed loans for the MHPI Program. Administrative expense for the ARMS Initiative Program is a fee paid to the U.S. Department of Agriculture Rural Business Cooperative Service for administering the loan guarantees under ARMS, which is a joint program.

Note 9. Inventory and Related Property

As of September 30	2006		2005	
(amounts in millions)				
Inventory, Net	$	83,861.1	$	79,699.1
Operating Materials & Supplies, Net		146,883.3		141,533.6
Stockpile Materials, Net		1,078.8		1,340.6
Total	$	231,823.2	$	222,573.3

Inventory, Net								
As of September 30	2006					2005		
(amounts in millions)	Inventory, Gross Value		Revaluation Allowance		Inventory, Net	Inventory, Net		Valuation Method
Inventory Categories								
Available and Purchased for Resale	$	86,473.7	$	(29,798.8)	56,674.9	$	54,451.6	LAC,MAC
Held for Repair		30,457.7		(4,108.7)	26,349.0		24,454.0	LAC,MAC
Excess, Obsolete, and Unserviceable		9,785.3		(9,785.3)	0.0		0.0	NRV
Raw Materials		43.1		0.0	43.1		25.8	MAC,SP,LAC
Work in Process		794.1		0.0	794.1		767.7	AC
Total	$	127,553.9	$	(43,692.8)	83,861.1	$	79,699.1	

Legend for Valuation Methods:

Adjusted LAC = Latest Acquisition Cost, adjusted for holding gains and losses	NRV = Net Realizable Value
SP = Standard Price	O = Other
AC = Actual Cost	MAC = Moving Average Cost

Restrictions

There are no restrictions on disposition of inventory as related to environmental liabilities or issues. Restrictions on disposition related to other liabilities include material pending litigation or negotiation with contractors or common carriers. This material is restricted from disposition until litigation or negotiation is completed. The balance of this restricted inventory as of September 30, 2006, was $89.9 million.

Generally, there are no restrictions on the use, sale, or disposition of inventory except in the following situations:

- Distributions without reimbursement are made when authorized by Department directives.
- War reserve material includes fuels and subsistence items that are considered restricted.
- Inventory, with the exception of safety stocks, may be sold to foreign, state and local governments, private parties, and contractors in accordance with the current policies and guidance or at the direction of the President.

General Composition of Inventory

Inventory includes spare and repair parts, clothing and textiles, and fuels held for sale by the Defense Working Capital Funds. Inventory is tangible personal property that is:

- Held for sale, or held for repair and eventual sale;
- In the process of production for sale; or
- To be consumed in the production of goods for sale or in the provision of service for a fee.

The relevant cost associated with maintaining the available inventory and the time required to replenish the inventory are the criteria used in determining the assigned category.

Operating Materials and Supplies, Net					
As of September 30	2006			2005	
(amounts in millions)	OM&S Gross Value	Revaluation Allowance	OM&S, Net	OM&S, Net	Valuation Method
OM&S Categories					
Held for Use	$ 130,617.2	$ (0.0)	$ 130,617.2	$ 126,300.0	SP, LAC
Held for Repair	17,624.0	(1,357.9)	16,266.1	15,233.6	SP, LAC
Excess, Obsolete, and Unserviceable	2,141.6	(2,141.6)	0.0	0.0	NRV
Total	$ 150,382.8	$ (3,499.5)	$ 146,883.3	$ 141,533.6	

Legend for Valuation Methods:
Adjusted LAC = Latest Acquisition Cost, adjusted for holding gains and losses
SP = Standard Price
AC = Actual Cost
NRV = Net Realizable Value
O = Other

Restrictions

Some munitions included in Operating Materials and Supplies (OM&S) are restricted for use. Restricted munitions are items that cannot be expected to meet performance requirements under all conditions. The restricted munitions are only used in emergency combat situations in which no other suitable munitions are immediately available.

General Composition of Operating Materials and Supplies

OM&S includes spare and repair parts, ammunition, tactical missiles, aircraft configuration pods, and centrally managed aircraft engines held for consumption. The Held for Use category includes a total of $56.9 million held for future use.

The relevant cost associated with maintaining the available operating materials and supplies, as well as the time required to replenish the operating materials and supplies, are the criteria used in determining the assigned category. There were no changes in accounting methods.

Stockpile Materials, Net					
As of September 30	2006			2005	
(amounts in millions)	Stockpile Materials Amount	Allowance for Gains (Losses)	Stockpile Materials, Net	Stockpile Materials, Net	Valuation Method
Stockpile Materials Categories					
Held for Sale	$ 984.7	$ 0.0	$ 984.7	$ 1,246.5	AC, LCM
Held in Reserve for Future Sale	94.1	0.0	94.1	94.1	AC, LCM
Total	$ 1,078.8	$ 0.0	$ 1,078.8	$ 1,340.6	
Legend for Valuation Methods:					
Adjusted LAC = Latest Acquisition Cost, adjusted for holding gains and losses			NRV = Net Realizable Value		
SP = Standard Price			LCM = Lower of Cost or Market		
AC = Actual Cost			O = Other		

Restrictions

There are legal restrictions on the use of stockpile materials. All materials held by the National Defense Stockpile (NDS) are classified as Material Held in Reserve until congressional action declares the materials are no longer required to be stockpiled, and are available for sale on the open market. Disposals cannot be made from the stockpile except under the following situations: (1) necessary upgrading, refining, or processing, (2) necessary rotation to prevent deterioration, (3) determination as excess with potential financial loss if retained, and (4) as authorized by law.

Mercury sales were voluntarily suspended by the NDS in 1994. The suspension was in response to concerns raised by the United States Environmental Protection Agency regarding the accumulation of mercury in the global environment. An Environmental Impact Statement was issued and storage consolidation at Hawthorne, Nevada, was the selected alternative.

Additional restrictions on the use of materiel are being proposed in the Requirements Report to Congress for beryllium metal, mica block, and quartz.

General Composition of Stockpile Materials

Stockpile materials are strategic and critical materials held due to statutory requirements for use in national defense, conservation, or national emergencies.

The Annual Materials Plan lists the maximum quantity of each commodity that may be sold by the Department in a given fiscal year. Before any materials may be sold, Congress must enact specific enabling legislation (e.g., the National Defense Authorization Act). When NDS receives authorization to offer materials for sale, NDS removes the materials from Material Held in Reserve and reclassifies them as Materials Held for Sale. The estimated market price of the stockpile materials held for sale is $1.5 billion.

Note 10. General PP&E, Net

As of September 30	2006					2005 Restated
(amounts in millions)	Depreciation/ Amortization Method	Service Life	Acquisition Value	(Accumulated Depreciation/ Amortization)	Net Book Value	Prior FY Net Book Value
Land	N/A	N/A	$ 10,533.4	$ N/A	$ 10,533.4	$ 10,479.4
Buildings, Structures, and Facilities	S/L	20 or 40	167,909.7	(98,454.5)	69,455.2	68,551.3
Leasehold Improvements	S/L	lease term	328.5	(161.3)	167.2	176.5
Software	S/L	2-5 or 10	8,669.4	(5,278.4)	3,391.0	3,484.3
General Equipment	S/L	5 or 10	59,784.4	(43,066.3)	16,718.1	16,582.2
Military Equipment	S/L	various	640,461.6	(295,516.6)	344,945.0	332,651.9
Assets Under Capital Lease	S/L	lease term	627.8	(478.1)	149.7	185.0
Construction-in- Progress	N/A	N/A	20,019.5	N/A	20,019.5	20,304.3
Other			61.6	(1.2)	60.4	126.5
Total General PP&E			$ 908,395.9	$ (442,956.4)	$ 465,439.5	$ 452,541.4
Legend for Valuation Methods:						
S/L = Straight Line			N/A = Not Applicable			

Military Equipment

The Department changed its method of valuing military equipment in 3rd Quarter, FY 2006. Previously, military equipment was valued using Bureau of Economic Analysis (BEA) data. Beginning with the 3rd Quarter, FY 2006, military equipment value was based on internal records. For comparative purposes, the value of military equipment for the 4th Quarter, FY 2005, was restated from $340.8 billion to $332.7 billion, using the new valuation method.

For 4th Quarter, FY 2006, military equipment is valued at $344.9 billion based on internal records. Under the previously used BEA valuation methodology, this equipment would have been valued at $349 billion.

Heritage Assets and Stewardship Land

The Federal Accounting Standards Advisory Board, Statement of Federal Financial Accounting Standards 29, "Heritage Assets and Stewardship Land," requires note disclosures for heritage assets and stewardship land. The Department is committed to preserving and accounting for its heritage assets' historical, cultural, educational, or artistic importance. Additionally, the Department has stewardship land not acquired in connection with General Property, Plant and Equipment (PP&E), such as land donated to the federal government and land previously recorded as public domain.

Heritage assets consist of buildings and structures, museums, major collections, monuments and memorials, archeological sites and cemeteries, while stewardship land consists mainly of mission essential (donated, public domain, executive order) land. The Department, with minor exceptions, uses most of the buildings and structures as part of its everyday activities and includes them on the Balance Sheet as multi-use heritage assets (capitalized and depreciated).

Other

The Department has restrictions on disposal of real property (lands and buildings) located outside the continental United States. The Department has the use of land, buildings, and other overseas facilities that are obtained through various international treaties and agreements negotiated by the Department of State.

The Department does not have the acquisition value for all General PP&E and uses several cost systems to provide real property values for financial statement reporting purposes.

Assets Under Capital Lease		
As of September 30	2006	2005
(amounts in millions)		
Entity as Lessee, Assets Under Capital Lease		
Land and Buildings	$ 619.6	$ 619.6
Equipment	8.2	10.9
Accumulated Amortization	(478.1)	(445.5)
Total Capital Leases	$ 149.7	$ 185.0

Assets Under Capital Lease consist primarily of leases for the Section 801 Family Housing Program.

Note 11. Liabilities Not Covered by Budgetary Resources

As of September 30	2006	2005
(amounts in millions)		
Intragovernmental Liabilities		
Accounts Payable	$ 1.0	$ 0.0
Debt	13.6	14.3
Other	7,754.1	7,619.4
Total Intragovernmental Liabilities	7,768.7	7,633.7
Nonfederal Liabilities		
Accounts Payable	371.9	425.4
Military Retirement and Other Federal Employment Benefits	1,524,140.2	1,483,425.0
Environmental Liabilities	65,343.7	62,239.1
Other Liabilities	14,664.4	14,014.3
Total Nonfederal Liabilities	1,604,520.2	1,560,103.8
Total Liabilities Not Covered by Budgetary Resources	1,612,288.9	1,567,737.5
Total Liabilities Covered by Budgetary Resources	347,143.6	305,625.7
Total Liabilities	$ 1,959,432.5	$ 1,873,363.2

Liabilities Not Covered by Budgetary Resources are those liabilities which are not legally obligated with realized budgetary resources as of the Balance Sheet date.

Intragovernmental Liabilities Other are primarily comprised of $5.9 billion in custodial liabilities and $1.4 billion in unfunded Employment Compensation Act liabilities.

Nonfederal Other Liabilities are comprised mainly of $9.3 billion in unfunded annual leave liabilities, $2.1 billion in nonenvironmental disposal contingent liabilities, $1.3 billion in contingent liabilities, and $1.2 billion in custodial liabilities.

Note 12. Accounts Payable

As of September 30	2006			2005
(amounts in millions)	Accounts Payable	Interest, Penalties, and Administrative Fees	Total	Total
Intragovernmental Payables	$ 1,549.8	$ N/A	$ 1,549.8	$ 2,058.0
Nonfederal Payables (to the Public)	27,318.9	2.0	27,320.9	28,575.4
Total	$ 28,868.7	$ 2.0	$ 28,870.7	$ 30,633.4

Intragovernmental accounts payable decreased $508.2 million (25%). The majority of the decrease is due to an overstatement of $452.3 million in intragovernmental accounts payable with the General Services Administration, Department of Transportation, and National Aeronautics and Space Administration that occurred during 4th Quarter, FY 2005. The Department is involved in ongoing reconciliation efforts with its major trading partners resulting in information that is more accurate and therefore reducing the reliance on the use of estimates.

Note 13. Debt

As of September 30	2006			2005	
(amounts in millions)	Beginning Balance	Net Borrowing	Ending Balance	Net Borrowing	Ending Balance
Agency Debt (Intragovernmental)					
Debt to the Treasury	$ 85.6	$ 123.3	$ 208.9	$ 0.1	$ 85.6
Debt to the Federal Financing Bank	381.5	(208.3)	173.2	(124.8)	381.5
Total Agency Debt	$ 467.1	$ (85.0)	$ 382.1	$ (124.7)	$ 467.1
Total Debt	$ 467.1	$ (85.0)	$ 382.1	$ (124.7)	$ 467.1

The outstanding debt consists of interest and principal payments due to the U.S. Treasury and the Federal Financing Bank (FFB).

Fluctuations

Debt to the Treasury

The $123.3 million (144%) increase consists primarily of a $112.5 million increase in direct loan borrowings for the Military Housing Privatization Initiative in FY 2006. In addition, $11.4 million of the increase is borrowing in 2nd Quarter, FY 2006 for a loan default relating to the Armament Retooling and Manufacturing Support Initiative. See Note 8 for further disclosures on both programs. This increase is offset by $0.6 million of principal repayments throughout FY 2006 for capital improvements to the Washington Aqueduct.

Debt to the Federal Financing Bank

Outstanding debt decreased $208.3 million (55%) as a result of the reduction in Maritime Prepositioning Ship loans. As part of the Afloat Prepositioning Force program, the Department makes loan repayments to the FFB on behalf of ship owners in lieu of capital lease payments to ship owners.

Note 14. Environmental Liabilities and Disposal Liabilities

As of September 30	2006			2005
(amounts in millions)	Current Liability	Noncurrent Liability	Total	Total
Environmental Liabilities--Nonfederal				
Accrued Environmental Restoration Liabilities				
Active Installations—Installation Restoration Program (IRP) and Building Demolition and Debris Removal (BD/DR)	$ 1,137.7	$ 7,947.1	$ 9,084.8	$ 10,123.9
Active Installations—Military Munitions Response Program (MMRP)	89.5	5,307.0	5,396.5	7,082.0
Formerly Used Defense Sites—IRP and BD/DR	158.1	4,011.4	4,169.5	4,227.5
Formerly Used Defense Sites--MMRP	86.7	14,710.6	14,797.3	14,584.0
Other Accrued Environmental Liabilities—Active Installations				
Environmental Corrective Action	44.4	683.0	727.4	623.2
Environmental Closure Requirements	8.3	401.1	409.4	176.5
Environmental Response at Operational Ranges	6.5	298.5	305.0	304.1
Other	10.8	770.6	781.4	561.5
Base Realignment and Closure (BRAC)				
Installation Restoration Program	260.8	2,621.7	2,882.5	2,849.2
Military Munitions Response Program	21.8	891.4	913.2	699.3
Environmental Corrective Action/Closure Requirements	30.0	151.2	181.2	206.5
Other	149.2	0.0	149.2	342.9
Environmental Disposal for Weapons Systems Programs				
Nuclear Powered Aircraft Carriers	0.0	5,604.3	5,604.3	6,426.1
Nuclear Powered Submarines	0.0	3,377.7	3,377.7	5,837.2
Other Nuclear Powered Ships	0.0	277.2	277.2	223.9
Other National Defense Weapons Systems	0.0	233.8	233.8	197.8
Chemical Weapons Disposal Program	2,461.0	14,996.3	17,457.3	10,450.0
Other	0.0	3,237.4	3,237.4	112.0
Total Environmental Liabilities	$ 4,464.8	$ 65,520.3	$ 69,985.1	$ 65,027.6

Service Component – Environmental Restoration (Cleanup) Liabilities and Environmental Disposal Liabilities					
(Amounts in millions)	Army	Navy	Air Force	ODO	Total
Environmental Liabilities-Nonfederal					
Accrued Environmental Restoration Liabilities:					
Active Installations--Installation Restoration Program(IRP) and Building Demolition and Debris Removal (BD/DR)	$ 2,919.2	$ 2,329.2	$ 3,638.6	$ 197.8	$ 9,084.8
Active Installations--Military Munitions Response Program (MMRP)	3,317.8	685.0	1,393.7	0.0	5,396.5
Formerly Used Defense Sites--IRP and BD/DR	4,169.5	0.0	0.0	0.0	4,169.5
Formerly Used Defense Sites--MMRP	14,797.3	0.0	0.0	0.0	14,797.3
Other Accrued Environmental Liabilities--Active Installations					
Environmental Corrective Action	372.0	40.6	136.9	177.9	727.4
Environmental Closure Requirements	96.9	185.8	99.5	27.2	409.4
Environmental Response at Operational Ranges	304.1	0.0	0.0	0.9	305.0
Other	689.0	0.0	0.0	92.4	781.4
Base Realignment and Closure (BRAC)					
Installation Restoration Program	523.7	1,117.1	1,204.9	36.8	2,882.5
Military Munitions Response Program	800.4	112.8	0.0	0.0	913.2
Environmental Corrective Action/Closure Requirements	32.3	67.5	81.4	0.0	181.2
Other	149.2	0.0	0.0	0.0	149.2
Environmental Disposal for Weapons Systems Programs					
Nuclear Powered Aircraft Carriers	0.0	5,604.3	0.0	0.0	5,604.3
Nuclear Powered Submarines	0.0	3,377.7	0.0	0.0	3,377.7
Other Nuclear Powered Ships	0.0	277.2	0.0	0.0	277.2
Other National Defense Weapons Systems	0.0	233.8	0.0	0.0	233.8
Chemical Weapons Disposal Program	17,457.3	0.0	0.0	0.0	17,457.3
Other	0.0	3,237.4	0.0	0.0	3,237.4
Total Nonfederal Environmental Liabilities:	$ 45,628.7	$ 17,268.4	$ 6,555.0	$ 533.0	$69,985.1

Others Category Disclosure Comparative Table		
As of September 30	2006	2005
(amounts in millions)		
Other Accrued Environmental Liabilities-Active Installations-Other		
U.S. Army Corps of Engineers Pollution Control & Abatement	$653.4	$529.6
Army Low Level Radioactive Waste Program	$35.8	$0.0
National Defense Stockpile (NDS) Transaction	$52.2	$0.0
Defense Commissary Agency	$29.0	$31.9
TRICARE Management Activity Uniformed Services University of Health Sciences - Operation and Maintenance	$11.0	$0.0
Total	$781.4	$561.5
Base Realignment and Closure (BRAC)-Other		
Army cleanup contracts at BRAC installations	$149.2	$112.1
Air Force contractual support for environmental program management at BRAC installations.	$0.0	$230.8
Total	$149.2	$342.9
Environmental Disposal for Weapons Systems Programs-Other		
Navy Spent Nuclear Fuel	$3,237.4	$0.0
NDS - Other Defense Organizations (ODO)	$0.0	$54.2
ODO's Environmental Disposal unliquidated obligations that cannot be identified to a specific program/project.	$0.0	$57.8
Total	$3,237.4	$112.0

Environmental Disclosures		
As of September 30	2006	2005
(amounts in millions)		
A. Amount of operating and capital expenditures used to remediate legacy waste. Legacy wastes are the remediation efforts covered by IRP, MMRP, and BD/DR regardless of funding source.	924.6	730.8
B. The unrecognized portion of the estimated total cleanup costs associated with general property, plant, and equipment.	1,527.4	152.1
C. The estimated cleanup costs associated with general property, plant, and equipment placed into service during each fiscal year.	0.0	0.0
D. Changes in total cleanup costs due to changes in laws, regulations, and/or technology.	(44.9)	0.0
E. Portion of the changes in estimated costs due to changes in laws and technology that is related to prior periods.	0.0	0.0

Fluctuations

Environmental Disclosures – Line A represents the amount of operating and capital expenditures used to remediate legacy waste. The amount on Line A increased $193.8 million (27%) from FY 2005. This increase is primarily due to increases in land sales and BRAC activity which led to a greater amount of environmental corrective actions and environmental restoration cleanup. The Department is working to more accurately disclose the amount of operating and capital resources disbursed to remediate legacy waste. As these processes are being developed, fluctuations due to updated information will occur.

Environmental Disclosures – Line B represents the unrecognized costs associated with General Property, Plant, and Equipment (PP&E). The amount on Line B increased approximately $1.4 billion from FY 2005, which is attributed to costs that were recognized in 3rd Quarter, FY 2006 for nuclear aircraft carriers and submarines, and conventional ships. The Department is working to more accurately disclose the unrecognized portion of the estimated cleanup costs associated with General PP&E. As these processes are being developed, fluctuations due to updated information will occur.

Environmental Disclosures – Line C represents the estimated cleanup costs associated with general property, plant, and equipment placed into service during the fiscal year. The Department is unable to report this cost due to system and internal control weaknesses. The Department is working to more accurately disclose estimates for cleanup cost in FY 2007.

Environmental Disclosures – Line D represents the amount of changes in total cleanup costs due to changes in laws, regulations, and/or technology. The decrease of $44.9 million represents an additional improvement in the method used to report this information for the Defense Environmental Restoration Program liability. This improvement is the result of an automated process used to track and report FY 2006 information, whereas the FY 2005 information was based on a manual process. The Department is working to specifically identify the causes for changes in estimated liabilities and to more accurately disclose estimates for costs due to changes in laws and technology.

Environmental Disclosures – Line E represents the portion of changes in estimated costs due to changes in laws and technology that is related to prior periods. The Department is unable to report this amount due to system and internal control weaknesses. The Department is working to more accurately disclose the amount of change in estimates for cost due to changes in laws and technology relating to prior periods in FY 2007.

Other Disclosures

Applicable Laws and Regulations for Cleanup Requirements

The Department is required to clean up contamination resulting from past waste disposal practices, leaks, spills, and other past activity that created a public health or environmental risk. The Department accomplishes this effort in coordination with regulatory agencies and, if applicable, other responsible parties and current property owners. The Department is also required to recognize closure and post-closure costs for its General PP&E and environmental corrective action costs for current operations. Each of the Department's major reporting entities is responsible for tracking and reporting all required environmental information related to environmental restoration

costs, other accrued environmental costs, disposal costs of weapons systems, and environmental costs related to BRAC actions that have taken place.

The Department follows the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) and the Superfund Amendment and Reauthorization Act to clean up Defense Environmental Restoration Program (DERP)-eligible contamination. Contamination clean up that is not eligible for DERP is performed in accordance with the Resource Conservation and Recovery Act (RCRA). The CERCLA and RCRA require the Department to clean up contamination in coordination with regulatory agencies, current owners of property damaged by the Department, and third parties that have a partial responsibility for the environmental restoration. Failure to comply with agreements and legal mandates will put the Department at risk of incurring fines and penalties.

The clean-up requirements for nuclear-powered aircraft carriers, submarines, and other nuclear ships are based on laws that affect the Department's conduct of environmental policy and regulations. The Atomic Energy Act of 1954, as amended, assures the proper management of source, special nuclear, and byproduct material. As in all cases with nuclear power, the Department coordinates actions with the Department of Energy. The Nuclear Waste Policy Act of 1982 requires all owners and generators of high-level nuclear waste and spent nuclear fuel to pay their respective shares of the full cost of the program. Finally, the Low Level Radioactive Waste Policy Amendments Act of 1986 provides for the safe and efficient management of low-level radioactive waste.

The Chemical Weapons Disposal Program is based on FY 1986 National Defense Authorization Act (PL 99-145, as amended by subsequent acts) that directed the Department to destroy the unitary chemical stockpile by April 29, 2004. The current guidelines for destruction are based on the Chemical Weapons Convention treaty. The United States ratified the treaty in April 1997, requiring the stockpile of chemical weapons to be destroyed by April 2007, according to the terms outlined. The Army, as Executive Agent within the Department, provides policy, direction, and oversight for both the Chemical Stockpile Program and the Nonstockpile Chemical Materiel Project. As such, the Army is responsible for the safe and economical disposal of the U.S. stockpile of lethal and incapacitating chemical warfare agents and munitions.

Methods for Assigning Total Cleanup Costs to Current Operating Periods

The Department uses engineering estimates and independently validated models to estimate environmental costs. The models are contained within the Remedial Action Cost Engineering Requirements and the Normalization of Data System. The Department validates the models in accordance with Department Instruction 5000.61 and primarily uses the models to estimate the liabilities based on data received during a preliminary assessment and initial site investigation. The Department primarily uses engineering estimates after obtaining extensive data during the remedial investigation/feasibility phase of the environmental project.

Once the environmental cost estimates are complete, the Department complies with accounting standards to assign costs to current operating periods. The Department has already expensed the costs for cleanup associated with General PP&E placed into service prior to October 1, 1997, unless the costs are intended to be recovered through user charges. If the costs are recovered through user charges, then the Department expensed that portion of the asset that has passed since the General PP&E was placed into service and is systematically recognizing the remaining cost over the life of the assets.

For General PP&E placed into service after September 30, 1997, the Department expenses the associated environmental costs systematically over the life of the asset. The Department expenses the full cost to clean up contamination for Stewardship PP&E at the time the asset is placed into service.

The Department uses two methods for systematic recognition: physical capacity for operating landfills, and life expectancy in years for all other assets.

Types of Environmental Liabilities and Disposal Liabilities Identified

The Department has clean-up requirements for the DERP sites at active installations, BRAC installations, Formerly Used Defense Sites, sites at active installations that are not covered by the DERP, weapon systems programs, and chemical weapons disposal programs. The weapons systems program consists of chemical weapons disposal, nuclear-powered aircraft carriers, nuclear-powered submarines, and other nuclear ships.

Nature of Estimates and the Disclosure of Information Regarding Possible Changes due to Inflation, Deflation, Technology, or Applicable Laws and Regulations

The Department had changes in estimates resulting from overlooked or previously unknown contaminants, reestimation based on different assumptions, and lessons learned. Environmental liabilities may change in the future due to changes in laws and regulation, changes in agreements with regulatory agencies, and advances in technology.

Uncertainty Regarding the Accounting Estimates used to Calculate the Reported Environmental Liabilities

The environmental liabilities for the Department are based on accounting estimates which require certain judgments and assumptions that are reasonable, based upon available information at the time the estimates are calculated. The actual results may materially vary from the accounting estimates if agreements with regulatory agencies require remediation to a different degree than anticipated when calculating the estimates. The liabilities can be further impacted if investigation of the environmental sites reveals contamination levels that differ from the estimate parameters.

The Department is uncertain regarding the extent of the liabilities at installations that are realigning or closing as a result of BRAC requirements. The Department is in the process of determining the extent of environmental liabilities at the BRAC installations, in particular those liabilities associated with unexploded ordnance on training ranges.

In addition to the liabilities reported above, the Department has the potential to incur costs for restoration initiatives in conjunction with returning overseas Defense facilities to host nations. The Department is unable to provide a reasonable estimate at this time because the extent of restoration required is not known.

The Army has a liability to take environmental restoration/corrective action for buried chemical munitions, and agents. The Army is unable to provide a reasonable estimate at this time, because the extent of the buried chemical munitions and agents is not known.

The Navy is currently surveying installations to identify the inventory of operational assets that may impact environmental liabilities. The Navy anticipates completing their survey and recording the impact on the environmental liability for the FY 2007 financial statements.

The U.S. Army Corps of Engineers is unable to provide a complete estimate for the Formerly Utilized Sites Remedial Action Program. The U.S. Army Corps of Engineers has studies on-going and will update its liabilities as it identifies additional liabilities.

Note 15. Other Liabilities

As of September 30	2006			2005
(amounts in millions)	Current Liability	Noncurrent Liability	Total	Total
Intragovernmental				
Advances from Others	$ 448.8	$ 0.0	$ 448.8	$ 394.6
Deposit Funds and Suspense Account Liabilities	2,009.3	0.0	2,009.3	742.1
Disbursing Officer Cash	2,273.2	0.0	2,273.2	2,092.0
Judgment Fund Liabilities	164.2	0.0	164.2	162.6
FECA Reimbursement to the Department of Labor	555.5	849.1	1,404.6	1,395.4
Other Liabilities	4,863.6	1,658.5	6,522.1	6,364.1
Total Intragovernmental Other Liabilities	10,314.6	2,507.6	12,822.2	11,150.8
Nonfederal				
Accrued Funded Payroll and Benefits	4,497.9	0.0	4,497.9	7,382.8
Advances from Others	2,074.3	0.0	2,074.3	1,697.5
Deferred Credits	0.0	0.0	0.0	11.8
Deposit Funds and Suspense Accounts	205.5	0.0	205.5	413.9
Temporary Early Retirement Authority	0.1	0.0	0.1	0.7
Nonenvironmental Disposal Liabilities				
(1) Military Equipment (Nonnuclear)	0.0	285.2	285.2	683.5
(2) Excess/Obsolete Structures	59.4	626.2	685.6	235.9
(3) Conventional Munitions Disposal	0.0	1,217.8	1,217.8	1,318.4
Accrued Unfunded Annual Leave	9,403.9	0.0	9,403.9	8,566.1
Capital Lease Liability	16.7	209.4	226.1	317.2
Other Liabilities	9,613.4	3,356.3	12,969.7	9,357.6
Total Nonfederal Other Liabilities	25,871.2	5,694.9	31,566.1	29,985.4
Total Other Liabilities	$ 36,185.8	$ 8,202.5	$ 44,388.3	$ 41,136.2

Fluctuations

Total Intragovernmental Other Liabilities increased approximately $1.7 billion (15%), primarily due to a $1.3 billion increase in Deposit Funds and Suspense Account Liabilities. This increase is attributable to timing differences in the amount of $490.3 million in the disbursement of payroll tax and Federal Insurance Contributions

Act withholdings in the 4th Quarter FY 2006. In 4th Quarter, FY 2005, the disbursement for these withholdings occurred in September 2005. In 4th Quarter, FY 2006, the disbursement did not occur until 1st Quarter, FY 2007. In addition, the Department processed collections from various contractors for the settlement of negotiations for contract nonperformance, resulting in a $480.9 million increase. The Department also implemented the Defense Finance and Accounting Service Transaction Interface Module - Intragovernmental Payment and Collection (DTIM-IPAC) in 3rd Quarter, FY 2006. The DTIM-IPAC greatly reduced disbursements that remained in suspense, thereby increasing Deposit Fund and Suspense Account Liabilities by $131.6 million.

Other Disclosures

Intragovernmental Other Liabilities are comprised primarily of custodial liabilities from accounts receivable for cancelled appropriations and interest, penalties, fines, and administrative fees from the public. The amounts collected cannot be used by the Department and must be distributed to the Treasury.

Nonfederal Other Liabilities primarily consist of contingent liabilities and other accrued liabilities for contractual services.

The Department has delinquent Federal Employment Compensation Act bills for 4th Quarter, FY 2006, totaling $9.7 thousand. The National Defense University owes the majority of the delinquency. The bill is expected to be paid during 1st Quarter, FY 2007.

Contingent Liabilities balance includes $3.3 billion in estimated future contract financing payments that will be paid to the contractor upon delivery and government acceptance of a satisfactory product. In accordance with contract terms, specific rights to the contractor's work vests with the government when a specific type of contract financing payment is made, thereby protecting taxpayer funds in the event of contract nonperformance. These rights should not be misconstrued as the rights of ownership. The Department is under no obligation to pay the contractor for amounts greater than the amounts authorized in the contract until delivery and government acceptance of a satisfactory product. Because it is probable that the contractor will complete its efforts and deliver a satisfactory product to the Department and the amount of potential future payments are estimable, the Department has recognized a contingent liability for estimated future payments, which are conditional pending delivery and government acceptance of a satisfactory product.

Capital Lease Liability					
As of September 30	2006 Asset Category				2005
(amounts in millions)	Land and Buildings	Equipment	Other	Total	Total
Future Payments Due					
2006	$ 0.0	$ 0.0	$ 0.0	$ 0.0	$ 64.0
2007	57.9	5.1	0.0	63.0	59.0
2008	47.1	0.2	0.0	47.3	51.1
2009	43.9	0.1	0.0	44.0	44.0
2010	43.9	0.0	0.0	43.9	43.9
2011	36.8	0.0	0.0	36.8	0.0
After 5 Years	52.0	0.0	0.0	52.0	137.6
Total Future Lease Payments Due	281.6	5.4	0.0	287.0	399.6
Less: Imputed Interest Executory Costs	60.8	0.1	0.0	60.9	82.4
Net Capital Lease Liability	$ 220.8	$ 5.3	$ 0.0	$ 226.1	$ 317.2
Capital Lease Liabilities Covered by Budgetary Resources				181.2	74.1
Capital Lease Liabilities Not Covered by Budgetary Resources				$ 44.9	$ 243.1

All leases entered into prior to FY 1992 are funded on an annual basis and subject to the availability of funds. Noncurrent amounts for these leases are shown as not covered by budgetary resources.

Leases originating after FY 1992 are required to be fully funded in the year of their inception. Therefore, budgetary resources show the present value of those lease payments as covered by budgetary resources.

Note 16. Commitments and Contingencies

Legal Contingencies

The Department is a party in various administrative proceedings and legal actions, with claims including environmental damage claims, equal opportunity matters, and contractual bid protests. The Department has accrued contingent liabilities for legal actions where the Department's Office of the General Counsel considers an adverse decision probable and the amount of loss is measurable. In the event of an adverse judgment against the government, some of the liabilities may be payable from the Judgment Fund. The Department records Judgment Fund liabilities in Note 12, "Accounts Payable" and Note 15, "Other Liabilities." See Notes 12 and 15 for details.

The Department's Office of General Counsel reported 65 legal actions with individual claims greater than the FY 2006 Department-wide materiality threshold of $107.6 million. Management determined that claims totaling approximately $484 billion had a remote probability of an adverse decision against the Department.

Other Commitments and Contingencies

The Department also had a number of potential claims that individually do not meet the FY 2006 Department-wide materiality threshold of $107.6 million, but do meet individual DoD Component materiality thresholds. These claims are disclosed in the Components' financial statements.

The undelivered orders for open (unfilled or unreconciled) contracts citing cancelled appropriations, for which the Department may incur a contractual commitment for payment, are $1.5 billion.

Note 17. Military Retirement and Other Federal Employment Benefits

As of September 30	2006				2005
(amounts in millions)	Present Value of Benefits	Assumed Interest Rate (%)	(Less: Assets Available to Pay Benefits)	Unfunded Liability	Present Value of Benefits
Pension and Health Actuarial Benefits					
Military Retirement Pensions	$ 963,696.1	6.0	$ (202,031.9)	$ 761,664.2	$ 892,111.6
Military Retirement Health Benefits	299,203.8	6.25	0.0	299,203.8	296,473.2
Military Medicare-Eligible Retiree Benefits	538,032.5	6.25	(84,268.7)	453,763.8	537,397.0
Total Pension and Health Actuarial Benefits	1,800,932.4		(286,300.6)	1,514,631.8	1,725,981.8
Other Actuarial Benefits					
FECA	6,856.0	5.17	0.0	6,856.0	6,918.9
Voluntary Separation Incentive Programs	1,391.2	4.0	(656.4)	734.8	1,495.7
Department Education Benefits Fund	1,785.3	5.2	(1,241.8)	543.5	1,661.4
Total Other Actuarial Benefits	10,032.5		(1,898.2)	8,134.3	10,076.0
Other Federal Employment Benefits	4,804.6		(3,430.5)	1,374.1	0.0
Total Military Retirement and Other Federal Employment Benefits:	$ 1,815,769.5		$ (291,629.3)	$ 1,524,140.2	$ 1,736,057.8

Actuarial Cost Method Used: Aggregate entry-age normal method
Assumptions: See below
Market Value of Investments in Market-based and Marketable Securities: $287.7 billion

Fluctuations

The present value of Military Retirement and Other Federal Employment Benefits increased $79.7 billion (5%) and is primarily attributable to an increase of $71.6 billion (8%) in the actuarial liability for Military Retirement Pensions. Other Federal Employment Benefits due and payable are included for FY 2006 and contributed another $4.8 billion to the increase. In prior years, these liabilities were reported in Note 15, "Other Liabilities."

Military Retirement Pensions

The $71.6 billion increase in the actuarial liability for Military Pensions is largely the result of a decrease in the assumed interest rate on invested balances, and thus a decrease in the associated assumed earnings of $32.8 billion and an increase in the actuarial liability. The majority of the remaining change is due to expected liability increases.

The Military Retirement Fund is a single-employer, defined benefit plan. Administrative costs of the Fund are not ascertainable. Projected revenues into the Fund, authorized by Public Law 98-94, come from three sources: interest earnings on Fund assets, monthly Department contributions, and annual contributions from the Treasury. The monthly Department contributions are determined as a percentage (approved by the Department's Retirement Board of Actuaries) of basic pay. The contribution from Treasury is paid into the Fund at the beginning of each fiscal year, and represents the amortization of the unfunded liability for service performed prior to October 1, 1984, as well as the amortization of actuarial gains and losses that have arisen since then. Effective FY 2005, Treasury began making an annual contribution to the Fund that represents the normal cost amount for the concurrent receipt provisions of the FY 2004 National Defense Authorization Act. The Board of Actuaries determines the Treasury's contribution, and the Secretary of Defense directs the Secretary of the Treasury to make the payment.

The long-term economic assumptions for each valuation are set by the Department's Retirement Board of Actuaries. The long-term assumptions for the FY 2005 valuation were 6.25 percent interest, 3.0 percent Consumer Price Index, and 3.75 percent salary increase. The long-term economic assumption for interest was lowered to 6.00 percent by the Board at its August 2006 meeting. Other assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on actual experience. Because of reporting deadlines, the current year actuarial present value of projected plan benefits is rolled forward, using accepted actuarial methods, from the prior year valuation results as reported in the Department's Office of Actuary Valuation of the Military Retirement System. For purposes of the Fund's financial reporting, this process is applied annually. In calculating the FY 2006 roll-forward amount, the following assumptions were used:

	Inflation	*Salary*	*Interest*
Fiscal Year 2006	4.1% (actual)	3.1% (actual)	6.0%
Fiscal Year 2007	3.0% (estimated)	2.7% (estimated)	6.0%
Long-Term	3.0%	3.75%	6.0%

Change in MRF Actuarial Liability	*(Amounts in billions)*
Actuarial Liability as of 9/30/05	$892.1
Expected Normal Cost for FY 2006	15.5
Plan Amendment Liability	0.1
Assumption Change Liability	35.3
Expected Benefit Payments for FY 2006	(40.5)
Interest Cost for FY 2006	55.0
Actuarial (gains)/losses due to changes in trend assumptions	6.1
Actuarial Liability as of 09/30/06	$963.7
Change in Actuarial Liability	**$71.6**

Actuarial Cost Method Used: Aggregate entry-age normal method.
Market Value of Investments in Market-Based and Marketable Securities: $202.9 billion

Military Retirement Health Benefits (MRHB)

The MRHB are post-retirement benefits the Department provides to non-Medicare-eligible military retirees and other eligible beneficiaries who are not Medicare-eligible, through private sector health care providers and Department Medical Treatment Facilities.

Change in MRHB Actuarial Liability	*(Amounts in billions)*
Actuarial Liability as of 09/30/05	
(Department pre-Medicare + all Uniformed Services Medicare cost-basis effect)	$296.5
Expected Normal Cost for FY 2006	10.0
Expected Benefit Payments for FY 2006	(9.3)
Interest Cost for FY 2006	18.9
Actuarial (gains)/losses due to other factors	39.4
Actuarial (gains)/losses due to changes in trend assumptions	(56.3)
Actuarial Liability as of 09/30/06	
(Pre-Medicare + all Uniformed Services Medicare cost-basis effect)	$299.2
Change in Actuarial Liability	**$ 2.7**

Actuarial Cost Method Used: Aggregate Entry-Age Normal
Assumed Interest Rate: 6.25%

Medical Trend	FY 2005 – FY 2006	Ultimate Rate 2030
Medicare Inpatient	5.62%	6.25%
Medicare Outpatient	7.83%	6.25%
Medicare Prescriptions (Direct Care)	8.13%	6.25%
Medicare Prescriptions (Purchased Care)	11.22%	6.25%
Non-Medicare Inpatient (Direct Care)	7.50%	6.25%
Non-Medicare Outpatient (Direct Care)	4.00%	6.25%
Non-Medicare Prescriptions (Direct Care)	7.00%	6.25%
Non-Medicare Inpatient (Purchased Care)	10.40%	6.25%
Non-Medicare Outpatient (Purchased Care)	7.40%	6.25%
Non-Medicare Prescriptions (Purchased Care)	12.11%	6.25%

Other Information

The MRHB liability represents Department pre-Medicare liabilities for direct care and purchase care benefits, plus the direct-care cost-basis effect for Medicare liabilities for all Uniformed Services. The cost-basis effect is approximately $28 billion as of September 30, 2006, and arises because liabilities for direct care in the total retiree health liability are valued at a higher cost basis than they are in the Medicare-Eligible Retiree Health Care Fund (MERHCF) liability. The $299.2 billion liability includes $600 million for the Coast Guard, $69.8 million for the Public Health Service, and $4.6 million for the National Oceanic and Atmospheric Administration (NOAA).

The actuarial liability reported above does not include $1.4 billion in incurred but not reported liabilities as of September 30, 2006. These liabilities are reflected in Other Federal Employment Benefits in the table above.

Military Medicare-Eligible Retiree Benefits

Public Law 106-398 authorized the establishment of the MERHCF for the purpose of accumulating funds to finance the health care program liabilities of Medicare-eligible retirees for all the Uniformed Services and specific Medicare-eligible beneficiaries. The Fund began operations on October 1, 2002. Projected revenues into the MERHCF, authorized by Chapter 56 of Title 10, United States Code, come from three sources: interest earnings on Fund assets, annual Uniformed Services "normal cost" contributions, and annual contributions from the Treasury. Prior to October 1, 2005, the normal cost contributions by the Services were paid monthly at per capita amount (approved by the Department MERHCF Board of Actuaries) times actual end strength. Beginning in FY 2006, the normal cost is paid annually at the beginning of the fiscal year by the Treasury, from amounts appropriated to the Military Services, and is calculated at the approved rate times the budgeted force strengths. The contribution from Treasury is also paid into the Fund at the beginning of each fiscal year and represents the amortization of the unfunded liability for services performed prior to October 1, 2002, as well as the amortization of actuarial gains and losses that have arisen since then. The Board determines Treasury's contribution, and the Secretary of Defense directs the Secretary of the Treasury to make the payment.

Assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on actual experience. Claims cost assumptions for direct care were based on actual experience. Assumptions for purchased care were developed from industry-based cost estimates adjusted to approximate the military retired population. Because of reporting deadlines, the current year actuarial present value of projected plan benefits is rolled forward, using accepted actuarial methods, from the prior year's results. For purposes of the Fund's financial reporting, this process is applied annually. In calculating the FY 2006 roll-forward amount, the following medical trend assumptions were used:

Medical Trend	FY 2005 – FY 2006	Ultimate Rate 2030
Medicare Inpatient	5.62%	6.25%
Medicare Outpatient	7.83%	6.25%
Medicare Prescriptions (Direct Care)	8.13%	6.25%
Medicare Prescriptions (Purchased Care)	11.22%	6.25%

Changes in MERHCF Actuarial Liability	*(Amounts in billions)*
Actuarial Liability as of 09/30/05 (all Uniformed Services Medicare)	$537.4
Expected Normal Cost for FY 2006	11.0
Expected Benefit Payments for FY 2006	(7.5)
Interest Cost for FY 2006	34.0
Actuarial (gains)/losses due to other factors	42.1
Actuarial (gains)/losses due to changes in trend assumptions	(79.1)
Actuarial Liability as of 09/30/06 (all Uniformed Services Medicare)	$538.0
Change in Actuarial Liability	**$0.6**

Actuarial Cost Method Used for MERHCF Liability: Aggregate Entry-Age Normal
Market Value of Investments in Market-Based and Marketable Securities: $83.0 billion
Assumed Interest Rate: 6.25%

The MERHCF liability includes Medicare liabilities for all Uniformed Services. The $538.0 billion liability includes $526.3 billion for the Department, $10.5 billion for the Coast Guard, $1.1 billion for the Public Health Service, and $100 million for NOAA. FY 2006 contributions from each of the services were: $10.8 billion by the Department, $300 million by the Coast Guard, $34.5 million by the Public Health Service, and $1.6 million by NOAA.

The actuarial liability reported above does not include $604.7 million in incurred but not reported liabilities as of September 30, 2006. These liabilities are included in Note 11 "Liabilities Not Covered and Covered by Budgetary Resources" and Note 15 "Other Liabilities".

Federal Employees Compensation Act (FECA)

Assumptions

The liability for future workers' compensation benefits includes the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases, plus a component for incurred but not reported claims. The liability is determined using a method that utilizes historical benefit payment patterns related to a specific incurred period to predict the ultimate payments related to that period. Consistent with past practice, these projected annual benefit payments have been discounted to present value using the Office of Management and Budget's economic assumptions for 10-year Treasury notes and bonds. A 5.17 percent interest rate was assumed in year 1 and 5.31 percent was assumed in year 2 and thereafter.

To provide more specifically for the effects of inflation on the liability for future workers' compensation benefits, wage inflation factors (cost of living adjustments or COLAs) and medical inflation factors (consumer price index medical or CPIMs) were applied to the calculation of projected future benefits. The actual rates for these factors for charge back year (CBY) 2006 were also used to adjust the methodology's historical payments to current year constant dollars.

The compensation COLAs and CPIMs used in the projections for various charge back years were as follows:

CBY	COLA	CPIM
2006	3.50%	4.00%
2007	3.13%	4.01%
2008	2.40%	4.01%
2009	2.40%	4.01%
2010	2.43%	4.09%

The model's resulting projections were analyzed to ensure that the estimates were reliable. The analysis was based on four tests: (1) a sensitivity analysis of the model of economic assumptions, (2) a comparison of the percentage change in the liability amount by agency to the percentage change in the actual payments, (3) a comparison of the incremental paid losses (the medical component in particular) in CBY 2006 (by injury cohort) to the average pattern observed during the prior three charge back years, and (4) a comparison of the ratio of the estimated liability to the actual payment of the beginning year calculated for the current projection to the liability-payment ratio calculated for the prior projection.

Voluntary Separation Incentive Programs (VSI)

Assumptions

The VSI program was established by Public Law 102-190. The intent of this program is to reduce the number of military personnel on active duty. This plan was offered to personnel with a minimum of six years of service who did not qualify for retirement. The incentive payments are spread over a period equivalent to twice the years of active service. The annual payment is based on 2.5% of the person's annual basic pay at the time they departed service multiplied by the number of years of service. The September 30, 2006, VSI Actuarial Present Value of Projected Plan Benefits (Actuarial Liability) was calculated at an assumed annual interest rate of 4%. Since the VSI program is no longer offered, each year the Actuarial Liability is expected to decrease with benefit outlays, and increase with interest cost. The present value of plan benefits actuarial liability for the VSI fund is $1.4 billion as of September 30, 2006. The liability was calculated, as in prior years, at the present value of all remaining payments as of September 30, 2006.

Market Value of Investments in Market-based and Marketable Securities: $615 million.

Department Education Benefits Fund (EBF)

The present value of plan benefits actuarial liability for the EBF is $1.8 billion as of September 30, 2006.

Assumptions

The EBF was established by Public Law 98-525. The program is designed to accumulate funds for the Educational Assistance program, to promote the recruitment and retention of members for the All-Volunteer Forces program and the Total Force Concept of the Armed Forces, and aid in the readjustment of members of the Armed Forces to civilian life after separation from military service.

Market Value of Investments in Market-based and Marketable Securities: $1.2 billion

Other Federal Employment Benefits

The format of this note was changed in FY 2006 to include Other Federal Employment Benefits, such as pension and other post-employment benefits due and payable, which were previously included in Note 15.

Note 18. General Disclosures Related to the Statement of Net Cost

Intragovernmental Costs and Exchange Revenue				
As of September 30	2006		2005	
(amounts in millions)				
Intragovernmental Costs	$	31,748.6	$	24,510.0
Public Costs		597,987.8		655,576.6
Total Costs		629,736.4		680,086.6
Intragovernmental Earned Revenue		(24,293.6)		(18,264.1)
Public Earned Revenue		(24,056.7)		(26,943.0)
Total Earned Revenue		(48,350.3)		(45,207.1)
Net Cost of Operations	$	581,386.1	$	634,879.5

Fluctuations

Total Costs decreased $50.4 billion (7%). This decrease was primarily due to a $33.1 billion reduction as the result of actuarial assumption changes for drug and other costs and a $57.5 billion reduction primarily due to costs incurred in FY 2005 and not in FY 2006 for a one-time actuarial adjustment in recognition of increasing numbers of retirees taking full advantage of their health care benefits. The decrease was partially offset by $27.3 billion in increased expenses in support of the Global War on Terror, hurricane relief in the Gulf of Mexico, and increased depreciation expense on military equipment.

Other Disclosures

The Department recorded a prior-period adjustment due to a change in the methodology for reporting military equipment. The FY 2005 restatement impacts the value of general property, plant, and equipment and associated accumulated depreciation reported on the Balance Sheet. The Department has determined that developing the prior year value for the depreciation expense is cost-prohibitive, and thus has elected not to restate the Statement of Net Cost (SNC).

The SNC is unique because its principles are driven on understanding the net cost of programs and/or organizations that the Federal Government supports through appropriations or other means. This statement provides gross and net cost information that can be related to the amount of output or outcome for a given program and/or organization administered by a responsible reporting entity. Intragovernmental costs and revenue are related to transactions made between two reporting entities within the Federal Government. Public costs and revenues are exchange transactions made between the reporting entity and a nonfederal entity.

For General Funds, the amounts presented in the SNC are based on obligations and disbursements and therefore may not, in all cases, accrue actual costs. While the Department's Working Capital Funds generally record transactions on an accrual basis, the systems do not always capture actual costs in a timely manner. As such, information presented in the SNC is based on budgetary obligations, disbursements, and collection transactions, as well as nonfinancial feeder systems, adjusted to record known accruals for major items such as payroll expenses, accounts payable, and environmental liabilities.

The majority of the Department's accounting systems do not capture information relative to Heritage Assets separately and distinctly from normal operations. Where it was able to separately identify the cost of acquiring, constructing, improving, reconstructing or renovating heritage assets, the Department has identified $2.3 million for the fiscal year.

Note 19. Disclosures Related to the Statement of Changes in Net Position

As of September 30	2006		2005 Restated	
(amounts in millions)	Cumulative Results of Operations	Unexpended Appropriations	Cumulative Results of Operations	Unexpended Appropriations
Prior Period Adjustments Increases (Decreases) to Net Position Beginning Balance				
Changes in Accounting Standards	$ 0.0	$ 0.0	$ 3,632.4	$ 0.0
Errors and Omissions in Prior Year Accounting Reports	(8,033.1)	0.0	(776.5)	0.0
Total Prior Period Adjustments	$ (8,033.1)	$ 0.0	$ 2,855.9	$ 0.0
Imputed Financing				
Civilian CSRS/FERS Retirement	$ 1,553.8	$ 0.0	$ 1,604.1	$ 0.0
Civilian Health	2,646.5	0.0	2,457.1	0.0
Civilian Life Insurance	26.1	0.0	24.7	0.0
Judgment Fund	183.2	0.0	379.4	0.0
IntraEntity	0.0	0.0	0.0	0.0
Total Imputed Financing	$ 4,409.6	$ 0.0	$ 4,465.3	$ 0.0

Prior Period Adjustments

The Department recognized prior period adjustments in FY 2006 and restated cumulative results of operations for FY 2005 and FY 2006 by $8.1 billion. The adjustments related to the revaluation of military equipment, and the recognition of a strategic petroleum reserve established in FY 1993 which was erroneously expensed at that time. Refer to Note 25, Restatements, for additional details relating to these adjustments.

Fluctuations

Budgetary Financing Sources, Appropriations Received increased $69.7 billion from FY 2005, largely due to increased funding received for the Global War on Terror. During FY 2006, the Department received $52.7 billion more in supplemental appropriations than in FY 2005. The balance of the increase is spread across the DoD appropriations.

Other Disclosures

The amounts the DoD remits to the Office of Personnel Management by and for employees covered by the Civil Service Retirement System, the Federal Employees' Retirement System, the Federal Employees' Health Benefits program, and the Federal Employees' Group Life Insurance program do not fully cover the government's cost to provide these benefits. An imputed cost is recognized as the difference between the government's cost of

providing these benefits to employees and the Department's contributions for them. The Office of Personnel Management provides cost factors for the computation of imputed financing costs, and their inclusion in the Department's financial statements.

Statement of Federal Financial Accounting Standards Number 27, "Identifying and Reporting Earmarked Funds," effective for reporting years after FY 2005, required that DoD modify the Statement of Changes in Net Position. The Federal Accounting Standards Advisory Board determined that restatement of prior comparative balances would not be allowed. To meet the requirement, additional columns were added to separately display gross amounts for earmarked funds, and all other (non-earmarked) funds. In the Statement of Changes in Net Position, all offsetting balances (i.e. transfers-in and transfers out, revenues and expenses) for intra-DoD activity between earmarked and other (non-earmarked) funds are reported on the same lines. This results in an eliminations column which appears to contain no balances. In reality, the column contains all appropriate elimination entries, but all net to zero within each respective line.

Fiscal year 2006 cumulative results of operation ending balance on the Statement of Changes in Net Position does not agree with the cumulative results reported on the Balance Sheet because the cumulative results on the Balance Sheet are presented net of eliminations.

There is an $87.0 billion difference between Appropriations Received that are reported on the Statement of Changes in Net Position ($594.7 billion) and Appropriations Received in the Statement of Budgetary Resources ($681.7 billion). This difference is primarily due to appropriations transferred to the trust and special funds which are duplicated in the Statement of Budgetary Resources. In addition, a small portion of the difference relates to interest collected by the trust funds. See Note 20, "Disclosures Related to the Statement of Budgetary Resources" for additional information.

Note 20. Disclosures Related to the Statement of Budgetary Resources

As of September 30	2006	2005
(amounts in millions)		
Net Amount of Budgetary Resources Obligated for Undelivered Orders at the End of the Period	$ 295,463.2	$ 275,627.9
Available Borrowing and Contract Authority at the End of the Period	26,045.7	28,006.3

Fluctuations

The Nonbudgetary Financing, Budgetary Resources section of the Statement of Budgetary Resources (SBR) reflects a decrease of $109.8 million (44%). This section of the SBR reports activity for the Military Housing Privatization and the Armament Retooling and Manufacturing Support Initiatives. The fluctuation was primarily due to a decline in borrowing authority and spending authority from offsetting collections without advance from federal sources. During FY 2005, there were no new direct loans issued for the year. However, in FY 2006, there were three new loans issued. The issuance of these new loans had a decreasing effect on borrowing authority and the value of unfilled customer orders without advance.

Reconciliation Differences

There is a difference of $33.5 billion between the Available Borrowing and Contract Authority reported ($26.0 billion) in the table above and the amount reported for Available Borrowing and Contract Authority on the SBR ($59.5 billion). The table above reports current-year activity as well as carry-forward amounts for both categories of authority. The SBR only reports current-year activity for these categories.

Appropriations Received on the Statement of Budgetary Resources (SBR) exceed Appropriations Received on the Statement of Changes in Net Position by $87.0 billion. Appropriations received at the Military Services and Defense Agencies that are subsequently recognized a second time on the SBR as appropriation transferred into trust and special funds comprise $68.2 billion of the excess. Interest earnings on the Military Retirement and Health Care investments make up an additional $16.4 billion. The balance of the difference consists primarily of other revenues collected into the Department's special and trust funds.

Permanent Indefinite Appropriations

The Department received the following permanent indefinite appropriations:

- Department of the Army General Gift Fund (10 USC 2601(b)(1))
- Department of the Navy General Gift Fund (10 USC 2601(b)(2))
- Department of the Air Force General Gift Fund (10 USC 2601 (b)(3))
- Foreign National Employees Separation Pay Account, Defense (10 USC 1581)
- United States Naval Academy Gift and Museum Fund (10 USC 6973-4)
- Ship Stores Profits, Navy (10 USC 7220, 31 USC 1321)
- Midshipmen's Store (10 USC 6971B)
- Burdensharing Contributions Account (10 USC 2350(j))
- Forest Program (10 USC 2665)
- Department of Defense Base Closure Account (10 USC 2687)
- Medicare Eligible Retiree Health Care Fund (MERHCF) (10 USC 1111)
- Military Retirement Fund (MRF) (10 USC 1461)
- Education Benefits Fund (10 USC 2006)
- Reserve Mobilization Income Insurance Fund (10 USC 12528)
- Host Nation Support for U.S. Relocation Activities (10 USC 2350(k))
- National Defense Sealift Fund (10 USC 2218)
- Environmental Restoration, Navy (10 USC 2702)
- Hydraulic Mining Debris Reservoir (33 USC 683)
- Maintenance and Operation of Dams and Other Improvements of Navigable Waters (16 USC 810(a))
- Payments to States (33 USC 701c-3)
- Wildlife Conservation (16 USC 670-670(f))
- Ainsworth Bequest (31 USC 1321)

The above permanent indefinite appropriations cover a wide variety of purposes to help the Department accomplish its missions. These purposes include (1) military retirees healthcare benefits, retirement and survivor pay, and education benefits for veterans; (2) environmental, coastal, and wildlife habitat restoration, and water

resources maintenance; (3) costs associated with the closure or realignment of military installations; (4) relocation of armed forces to a host nation; (5) separation payments for foreign nationals; (6) the construction, purchase, alteration, and conversion of sealift vessels; and (7) upkeep of libraries and museums. Reference Note 23 for additional information on those funds that are earmarked.

Other Disclosures

The Department received supplemental appropriations totaling $130.5 billion to address the Global War on Terror, the hurricane relief effort in the Gulf of Mexico, and the Pandemic Influenza Act.

The SBR includes intraentity transactions because the statements are presented as combined and combining.

The Department utilizes borrowing authority for the Military Housing Privatization and the Armament Retooling and Manufacturing Support Initiatives.

There are no legal arrangements affecting the use of unobligated balances of budget authority.

The Department reported the following amounts of direct obligations: $469.4 billion in category A; $129.9 billion in category B, and $47.2 billion in exempt from apportionment. The Department reported the following amounts of reimbursable obligations: $96.9 billion in category A; $62.7 billion in category B; and $5.9 billion in exempt from apportionment. Category A relates to appropriations for a specific period of time (e.g., Military Personnel appropriation), and category B relates to appropriations for a specific project (e.g., Military Construction appropriation).

Note 21. Disclosures Related to the Statement of Financing

Due to the Department's financial system limitations, budgetary data is not in agreement with proprietary expenses and assets capitalized. The difference between budgetary and proprietary data is a previously identified deficiency. To bring the Statement of Financing into balance with the Statement of Net Cost, the following adjustments (absolute value) were made:

Resources That Finance the Acquisition of Assets	$11.3 billion
Other - Other Components Not Requiring or Generating Resources	$12.0 million

The following Statement of Financing lines are presented as combined instead of consolidated due to intra-agency budgetary transactions not being eliminated:

- Obligations Incurred
- Less: Spending Authority from Offsetting Collections and Recoveries
- Obligations Net of Offsetting Collections and Recoveries
- Less: Offsetting Receipts
- Net Obligations
- Undelivered Orders
- Unfilled Customer Orders

Fluctuations

Resources Used to Finance Activities

Other Resources – Other increased $5.6 billion primarily due to a change in accounting procedures in 1st Quarter, FY 2006 requiring the inclusion of nonexchange gains and losses necessary to reconcile the proprietary and budgetary accounts. This increase is also comprised of other gains and losses to adjust intragovernmental transfers in and transfers out of construction in progress amounts and property.

Resources Used to Finance Items not Part of the Net Cost of Operations

Resources That Finance the Acquisition of Assets increased $19.2 billion due primarily to a change in the military equipment valuation methodology implemented 3rd Quarter, FY 2006. See Note 10 for further disclosure on military equipment.

Components Requiring or Generating Resources

Components Requiring or Generating Resources in Future Period-Other decreased $94.3 billion due to future funded expenses that are not funded in the period the costs are incurred primarily related to the change in actuarial liability as discussed in Note 17.

Components not Requiring or Generating Resources

Other decreased $29.2 billion primarily due to cost capitalization offsets and other expenses not requiring budgetary resources.

Other Disclosures

The Department recorded other expenses not requiring budgetary resources of $281.8 million to reconcile budgetary activity with current period expenses for allocation transfers. The Department executed allocation transfers on behalf of the Department of Agriculture, Department of Transportation, and Department of Energy for various public work projects. These items include the treatment of disease in trees due to infestation for the State and Private Forestry, public bridge inventory and inspection of the Federal Lands Highway Program, and the maintenance of hydroelectric plants that the U.S. Army Corps of Engineers operates. In addition, the Department executed the funding for Iraqi Relief and Reconstruction Fund on behalf of the Executive Office of the President and Department of Transportation.

Liabilities not covered by budgetary resources on the Balance Sheet total $1.6 trillion and the amount reported as components requiring or generating resources in future periods on the Statement of Financing totals $86.8 billion. The difference of $1.5 trillion is primarily due to the differing perspectives between the two statements. Liabilities not covered by budgetary resources report the cumulative balance for Balance Sheet liabilities not yet funded whereas components requiring or generating resources in future periods reflect only the current period changes for all unfunded liabilities.

Note 22. Disclosures Related to the Statement of Custodial Activity

The Statement of Custodial Activity displays current year collections and disbursements for three custodial accounts: (1) Foreign Military Sales, (2) Development Fund for Iraq, and (3) Seized Assets. Funds held in a custodial activity are only used for the stated purposes and are not available for the Department's use.

Foreign Military Sales

Under authority of the Arms Export and Control Act, the Foreign Military Sales Trust Fund (FMSTF) receives collections from foreign governments that are dedicated specifically to FMS purchases. Funds collected into the FMSTF are in advance of the performance of services or sale of articles. These advance collections constitute a fiduciary relationship with the countries.

Current year Deposits by Foreign Governments into FMSTF are $13.7 billion. Disbursements on Behalf of Foreign Governments and International Organizations total $12.5 billion.

The FMSTF neither recognizes nor reports revenue, except for cost clearing accounts, which are reflected in all other principal financial statements. Since various Department Components actually perform the services and sell the articles, recognition of revenue and expense occurs in the financial statements of the applicable Department Components.

Development Fund for Iraq (DFI)

The DFI is for urgent humanitarian assistance, reconstruction, and other projects carried out for the benefit of the Iraqi people. During FY 2006, there were $34.6 million in disbursements by the Multi-National Force Iraq with no additional deposits. As of September 30, 2006, $18.8 million remains to be disbursed. The Department made adjustments in 1st Quarter, FY 2006 for prior year disbursements, which resulted in a negative disbursement amount for Education, Refugees, Human Rights, and Governance, on the following page.

(amounts in millions)	During FY 2006	Cumulative from Inception
Source of Collections		
Deposits By Foreign Governments	$ 0	$ 136.0
Disposition of Collections		
Security and Law Enforcement	$ .2	$ 1.0
Electric Sector	20.8	45.2
Oil Infrastructure	0	.4
Water Resources and Sanitation	9.9	16.6
Transportation and Telecommunications	.1	5.3
Roads, Bridges and Construction	.8	5.0
Health Care	.2	2.9
Private Sector Development	3.4	7.2
Education, Refugees, Human Rights, and Governance	(.8)	33.6
Total Disbursed on Behalf of Foreign Governments	34.6	117.2
Retained for Future Support of Foreign Governments *	(34.6)	18.8
Total Disposition of Collections	$ 0	$ 136.0
Net Custodial Collection Activity	$ 0	$ 0

**Note – Reported on the Statement of Custodial Activity under Disposition of Collections, Increase (Decrease) in Amounts to be Transferred.*

Seized Assets

During Operation Iraqi Freedom, the U.S. Government seized assets from the Iraqi Government that are used in support of the Iraqi people. In FY 2006, $31.2 million was disbursed with no additional seized assets. As of September 30, 2006, $30.2 million of seized monetary assets remain to be disbursed in support of the Iraqi people as shown below.

(amounts in millions)	During FY 2006	Cumulative from Inception
Source of Collections		
Seized Iraqi Cash	$ 0	$ 927.2
Disposition of Collections		
Iraqi Salaries	$ 0	$ 30.8
Repair/Reconstruction/Humanitarian Assistance	31.2	526.2
Iraqi Ministry Operations (Ministry of Finance, Defense, etc.)	0	264.7
Fuel/Supplies	0	75.3
Total Disbursed on Behalf of Iraqi People	31.2	897.0
Retained for Future Support of Foreign Governments	(31.2)	30.2
Total Disposition of Collections	$ 0	$ 927.2
Net Custodial Collection Activity	$ 0	$ 0

Note 23. Earmarked Funds

BALANCE SHEET As of September 30, 2006 (amounts in millions)	MRF	MERHCF	Other Earmarked Funds	Eliminations	Total
ASSETS					
Fund balance with Treasury	$ 30.7	$ 37.9	$ 1,787.8	$ 0.0	$ 1,856.4
Investments	208,392.1	85,395.0	5,474.1	(0.1)	299,261.1
Accounts and Interest Receivable	23.3	8.8	468.2	(26.4)	473.9
Other Assets	0.0	0.0	1,767.5	0.0	1,767.5
Total Assets	$ 208,446.1	$ 85,441.7	$ 9,497.6	$ (26.5)	$ 303,358.9
LIABILITIES and NET POSITION					
Military Retirement Benefits and Other Federal Employment Benefits	$ 967,106.1	$ 538,032.8	$ 3,176.5	$ 0.0	$ 1,508,315.4
Other Liabilities	1.3	876.9	949.8	(64.0)	1,764.0
Unexpended Appropriations	0.0	0.0	11.4	0.0	11.4
Cumulative Results of Operations	(758,661.3)	(453,468.0)	5,360.0	(64,915.2)	(1,271,684.5)
Total Liabilities and Net Position	$ 208,446.1	$ 85,441.7	$ 9,497.7	$ (64,979.2)	$ 238,406.3
STATEMENT OF NET COST For the Year Ended September 30, 2006					
Program Costs	$ 112,821.7	$ 7,610.6	$ 3,120.2	$ (2,422.4)	$ 121,130.1
Less Earned Revenue	(51,737.7)	(31,802.7)	(1,005.4)	67,512.1	(17,033.7)
Net Program Costs	$ 61,084.0	$ (24,192.1)	$ 2,114.8	$ 65,089.7	$ 104,096.4
Less Earned Revenues Not Attributable to Programs	0.0	0.0	0.0	0.0	0.0
Net Cost of Operations	$ 61,084.0	$ (24,192.1)	$ 2,114.8	$ 65,089.7	$ 104,096.4
STATEMENT OF CHANGES IN NET POSITION As of September 30, 2006					
Net Position Beginning of the Period	$ (697,577.3)	$ (477,660.1)	$ 4,374.7	$ 0.0	$ (1,170,862.7)
Net Cost of Operations	61,084.0	(24,192.1)	2,114.8	65,089.7	104,096.4
Budgetary Financing Sources	0.0	0.0	3,288.9	174.3	3,463.2
Other Financing Sources	0.0	0.0	(177.4)	0.2	(177.2)
Change in Net Position	$ (61,084.0)	$ 24,192.1	$ 996.7	$ (64,915.2)	$ (100,810.4)
Net Position End of Period	$ (758,661.3)	$ (453,468.0)	$ 5,371.4	$ (64,915.2)	$ (1,271,673.1)

The Statement of Federal Financial Accounting Standards 27 (SFFAS 27), "Identifying and Reporting Earmarked Funds," requires the disclosure of Earmarked Funds separately from All Other Funds on the Statement of Changes in Net Position and Balance Sheet. Funds must meet three criteria to be classified as earmarked: (1) a statute committing use of specifically identified revenues for designated purposes, (2) explicit authority to retain the revenues, and (3) a requirement to account and report on the revenues. The Department earmarked funds are

either special or trust funds and use both receipt and expenditure accounts to report activity to the Treasury. There have been no changes in legislation during or subsequent to this reporting period that significantly changed the purposes of any of the funds.

The Total Earmarked Funds column is shown as consolidated and relates only to Earmarked Funds. The elimination column on this note includes only eliminations associated with Earmarked Funds and exludes the offsetting eliminations from All Other Funds. This exclusion causes assets to not equal liabilites and net position in the note. However, the amount in the Total column equal the amounts reported for Earmarked Funds on the Balance Sheet.

The SFFAS 27, effective for reporting years after FY 2005, required that DoD modify the Statement of Changes in Net Position. To meet the requirement, additional columns were added to separately display gross amounts from Earmarked Funds and All Other (non-earmarked) Funds. Cumulative Results of Operations ending balances for Earmarked Funds on the Statement of Changes in Net Position do not agree with the Cumulative Results of Operations for Earmarked Funds reported on the Balance Sheet because the Cumulative Results on the Balance Sheet are presented net of eliminations. The summation for MRF, MERCHF, and Other Earmarked Funds is equivalent to the gross amount presented on the Statement of Changes in Net Position.

Military Retirement Fund (MRF), 10 United States Code (USC) 1461. The MRF accumulates funds in order to finance, on an actuarially sound basis, the liabilities of the Department military retirement and survivor benefit programs. Financing sources for the MRF are interest earnings on Fund assets, monthly Department contributions, and annual contributions from the Treasury. The monthly Department contributions are determined as a percentage of basic pay. The contribution from Treasury represents the amortization of the unfunded liability for service performed prior to October 1, 1984, as well as the amortization of actuarial gains and losses that have arisen since then. The Treasury annual contribution also includes the normal cost amount for the concurrent receipt provisions of the fiscal year 2004 National Defense Authorization Act.

Medicare-Eligible Retiree Health Care Fund (MERHCF), 10 USC 1111. The MERHCF accumulates funds to finance, on an actuarially sound basis, liabilities of the Department and the uniformed services health care programs for specific Medicare-eligible beneficiaries. The MERHCF was authorized by Public Law 106-398. Financing sources for MERHCF are provided primarily through an annual actuarial liability payment from Treasury, annual contribution(s) from the Military Services and other Uniformed Services (US Coast Guard, the National Oceanic and Atmospheric Administration, and the US Public Health Service), and interest earned from the Fund's investments.

Other Earmarked Funds

Special Recreation Use Fees, 16 USC 4061-6a note. The United States Army Corps of Engineers (USACE) is granted the authority to charge and collect fair and equitable Special Recreation Use Fees at campgrounds located at lakes or reservoirs that are under the jurisdiction of the USACE. Types of allowable fees include, but are not limited to, daily use fees, admission fees, recreational fees, annual pass fees, and other permit type fees. The receipts are used for the operation and maintenance of the recreational sites.

Hydraulic Mining in California, Debris, 33 USC 683. Operators of hydraulic mines through which debris flows in part or in whole to a body restrained by a dam or other work erected by the California Debris Commission are

required to pay an annual tax as determined by the Commission. Taxes imposed under this code are collected and then expended under the supervision of the USACE and the direction of the Department of the Army. The funds are used for repayment of funds advanced by the federal government or other agency for construction, restraining works, settling reservoirs, and maintenance.

Payments to States, Flood Control Act of 1954, 33 USC 701c-3. Seventy-five percent of all funds received and deposited from the leasing of lands acquired by the United States for flood control, navigation and allied purposes, including the development of hydroelectric power, are returned to the state on which the property is located. The USACE collects lease receipts into a receipt account. Funds are appropriated for the amount of receipts the following fiscal year.

Maintenance and Operation of Dams and Other Improvements of Navigable Waters, 16 USC 803(f) and 810. The United States Code (USC) states, "all proceeds from any Indian reservation shall be placed to the credit of the Indians of such reservation." However, the USC also states, "all other charges arising from licenses" except those charges established by the Federal Power Commission, now known as the Federal Energy Regulatory Commission, for purpose of administrative reimbursement shall be paid to the Treasury from which specific allocations will be made. From the specific allocations, 50% of charges from "all other licenses" is reserved and appropriated as a special fund in the Treasury to be expended under the direction of the Secretary of the Army in the maintenance, operation and improvement of dams and other navigation structures that are owned by the United States or in construction, maintenance, or operation of headwater or other improvements of navigable waters of the United States.

Fund for Non-Federal Use of Disposal Facilities (for dredged material), 33 USC 2326. Any dredged material disposal facility under the jurisdiction of, or managed by, the Secretary of the Army (Secretary) may be used by a nonfederal interest if the Secretary determines that such use will not reduce the availability of the facility for project purposes. Fees may be imposed to recover capital, operation and maintenance costs associated with such use. Any monies received through collection of fees under this law shall be available to, and used by, the Secretary for the operation and maintenance of the disposal facility from which the fees were collected.

South Dakota Terrestrial Wildlife Habitat Restoration Trust Fund, Public Law 106-53 Sec. 603. Yearly transfers are made from the General Fund of the Treasury to the Trust Fund for investment purposes. Investment activity is managed by the Bureau of Public Debt (BPD). The BPD purchases and redeems nonmarketable market-based securities issued by the BPD. Investments include one-day certificates, bonds and notes. When the fund reaches the aggregate amount of $108 million, withdrawals may be made by the USACE for payment to the State of South Dakota. The state uses the payments to fund the annually scheduled work for wildlife habitat restoration.

Coastal Wetlands Restoration Trust Fund and Coastal Wetlands Planning, Protection and Restoration Act, 16 USC 3951-3956. The USACE, (along with the Environmental Protection Agency, and the Fish and Wildlife Service) is granted the authority to work with the State of Louisiana to develop, review, evaluate, and approve a plan to achieve a goal of "no net loss of wetlands" in coastal Louisiana. The USACE is also responsible for allocating funds among the named task force members. Federal contributions are established at 75% of project costs or 85% if the State has an approved Coastal Wetlands Conservation Plan.

Rivers and Harbors Contributed and Advance Funds, 33 USC 701h, 702f, and 703. Whenever any state or political subdivision offers to advance funds for a flood control project duly adopted and authorized by law, the Secretary of the Army, may in his discretion, receive such funds and expend them in the immediate prosecution of such work. The funding may be used to construct, improve, and maintain levees, water outlets, flood control, debris removal, rectification and enlargement of river channels, etc. in the course of flood control and river/harbor maintenance.

Inland Waterways Trust Fund, 26 USC 9506. This law made the Inland Waterways Trust Fund available for USACE expenditures for navigation, construction, and rehabilitation projects on inland waterways. Collections for excise taxes from the public are made into the Trust Fund. The collections are invested and investment activity is managed by the BPD. The BPD purchases and redeems nonmarketable market-based securities issued by the BPD. Investments include one-day certificates, bonds and notes. The fund is classified as a trust fund and utilizes receipt and expenditure accounts in accounting for and reporting the fund.

Harbor Maintenance Trust Fund, 26 USC 9505. The USACE Civil Works mission is funded by the Energy and Water Developments Appropriations Act. The Water Resources Development Act of 1986 was implemented to cover a portion of USACE operations and maintenance costs for deep draft navigation. The Harbor Maintenance Trust Funds is available for making expenditures to carry out the functions specified in the act and for the payment of all expenses of administration incurred by the Treasury, USACE, and the Department of Commerce. Collections are made into the Trust Fund from taxes collected from imports, domestics, passengers and foreign trade. The collections are invested and investment activity is managed by the BPD. The fund is classified as a trust fund and utilizes receipt and expenditure accounts in accounting for and reporting the fund.

Foreign National Employees Separation Pay Account Trust Fund, 10 USC 1581. This fund is used to make payments from amounts obligated by the Secretary of Defense that remain unexpended for separation pay for foreign national employees of the Department. The foreign national employees' separation pay funded by Foreign Military Sales administrative funds is maintained as a separate fund.

Defense Commissary Agency Surcharge Revenue, 10 USC 2685. The Defense Commissary Agency Surcharge account was established as the repository for the surcharge on the cost of commissary goods paid for by authorized patrons to finance certain operating expenses and capital purchases of the Commissary System, which are precluded by law from being paid with appropriated funds. The major part of the Surcharge public revenue is generated by the 5% surcharge applied to each sale. These funds may be used to pay for the commissary store-related information technology investments, to purchase commissary equipment, to finance advance design modifications to prior year projects, for both minor and major construction projects and to maintain and repair commissary facilities and equipment. The surcharge account also allows for obligations based on anticipated proceeds without regard to fiscal year limitations, if needed to carry out the uses of the revenue as identified.

Note 24. Other Disclosures

As of September 30	2006 Asset Category			
(amounts in millions)	Land and Buildings	Equipment	Other	Total
ENTITY AS LESSEE-Operating Leases				
Future Payments Due				
FY 2007	$ 188.9	$ 1.3	$ 124.2	$ 314.4
FY 2008	176.6	0.1	127.9	304.6
FY 2009	163.9	0.1	131.7	295.7
FY 2010	155.8	0.1	135.7	291.6
FY 2011	173.0	0.0	139.8	312.8
After 5 Years	188.6	0.0	143.4	332.0
Total Future Lease Payments Due	$ 1,046.8	$ 1.6	$ 802.7	$ 1,851.1

Note 25. Restatements

The Department posted prior period adjustments due to material errors that reduced the FY 2005 and FY 2006 beginning cumulative results of operations by $8.1 billion. The total is comprised primarily of an adjustment due to a change in the methodology for reporting of military equipment resulting in an $8.2 billion restatement, offset slightly by a $124.9 million adjustment to recognize an intragovernmental other asset for 6.4 million barrels of crude oil held by the Department of Energy on behalf of the DoD. A portion of the military equipment adjustment also impacted the FY 2005 Statement of Net Cost however the cost and manpower to develop the prior year value for the depreciation expense prohibited the Department from restating the Statement of Net Cost.

Military Equipment Adjustment

In accordance with Statement of Federal Financial Accounting Standards (SFFAS) Number 23, Eliminating the Category National Defense Property, Plant, and Equipment, the Department reported military equipment values in the financial statements beginning in FY 2003. As an interim measure, while the Department worked to develop its military equipment baseline from internal records, the military equipment values reported were based on estimates obtained from the Bureau of Economic Analysis (BEA).

Effective 3rd Quarter, FY 2006, the Department replaced the BEA estimation methodology with a valuation based on transaction level details. During the process of establishing a baseline, the Department discovered that the BEA estimates had failed to consider disposals, thresholds, and construction in process. While an estimation methodology is acceptable per SFFAS Number 23, due to the nature of the BEA omissions, the Department considers that the method previously used was not compliant with Generally Accepted Accounting Principles, and thus have treated the adjustment as correction of a material error.

The resulting adjustment decreased the value of general property, plant, and equipment and associated accumulated depreciation. This reduced General Plant, Property and Equipment, Net on in the Balance Sheet by $8.2 billion for FY 2005 and FY 2006.

Intragovernmental Other Asset for Strategic Petroleum Reserve

During FY 2006, as part of the trading partner reconciliation process, the Department recognized that it had erroneously expensed funds provided to the Department of Energy (DoE) in FY 1993 for the acquisition of a strategic petroleum reserve for national defense purposes. Legislation enacted in November 1992 Public Law 102-396, Sec. 9149 provided appropriations to DoD and established the requirement that they be transferred to DoE to acquire and maintain the reserve for national defense purposes on behalf of DoD. By law, the reserve cannot be drawn down or released to DoD without the President (with the advice of the Secretary of Defense) making findings under Section 161(d) of the Energy Policy and Conservation Act (42 USC 6241(d)). According to the law, proceeds of any sales of this reserve will be deposited to the accounts of, and remain available to DoD until expended. Due to the unusual nature of this asset and the specifics of the law that enacted the requirement the Department considered it qualitatively material and chose to recognize the asset with restatement.

In 4th quarter, FY 2006 DoD increased the value of Other Assets for FY 2005 and FY 2006 in the Balance Sheet by $124.9 million to recognize the right to the approximately 6.4 million barrels of crude oil. The DoE reports this crude oil as a non-entity asset in its financial statements, with an offsetting custodial liability to DoD. To date none of the reserve has been drawn upon, thus the full inventory remains on hand with DoE.

Required Supplementary Stewardship Information

Nonfederal Physical Property

Department Of Defense Consolidated
Nonfederal Physical Property
Annual Investments In State And Local Governments For Fiscal Years 2002 Through 2006
(In Millions Of Dollars)

Categories	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006
Transferred Assets:					
National Defense Mission Related	$7	$85	$54	$71	$1,295
Funded Assets:					
National Defense Mission Related	$21	$11	$18	$8	$9
Total	$28	$96	$72	$79	$1,304

The Department incurs investments in Nonfederal Physical Property for the purchase, construction, or major renovation of physical property owned by state and local governments, including major additions, alterations, and replacements, the purchase of major equipment, and the purchase or improvement of other physical assets. In addition, Nonfederal Physical Property Investments include federally-owned physical property transferred to state and local governments. The significant increase in assets from FY 2005 to FY 2006 is a result of assets now reported by the U.S. Army Corps of Engineers.

Investment values included in this report are based on Nonfederal Physical Property outlays (expenditures). Outlays are used because current Department accounting systems are unable to capture and summarize costs in accordance with federal accounting standards.

Investments in Research and Development

Department Of Defense Consolidated
Investments In Research And Development
Annual Investments In Research And Development For Fiscal Years 2002 Through 2006
(In Millions Of Dollars)

Categories	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006
Basic Research	$1,356	$1,444	$1,554	$1,404	$1,342
Applied Research	4,311	4,388	4,639	4,527	4,433
Development					
Advanced Technology Development	4,604	5,080	6,178	7,045	5,904
Demonstration and Validation	10,525	11,928	14,779	15,971	13,581
Engineering and Manufacturing Development	9,500	11,234	14,633	16,190	17,454
Research, Development, Test & Evaluation Management Support	3,351	3,210	4,188	4,431	4,719
Operational Systems Development	11,804	12,289	14,906	16,324	15,060
Total	$45,451	$49,573	$60,877	$65,892	$62,493

Investment values included in this report are based on Research and Development outlays (expenditures). Outlays are used because current Department accounting systems are unable to capture and summarize costs in accordance with the federal accounting standards.

Research and Development programs are classified in the following categories: Basic Research, Applied Research, and Development. The following table presents representative program examples for each of the major Research and Development categories and highlights outcomes.

Department of Defense Investments in Research and Development	
Basic Research Systematic study to gain knowledge or understanding of the fundamental aspects of phenomena and of observable facts without specific applications, processes, or products in mind.	
Major Program Areas	Outcomes
Defense Research Sciences	Provides new technologies for the Army's Future Force, and fosters innovation in niche areas where investment is lacking due to limited markets.
University and Industry Research Centers	Leverages research in the private sector through Collaborative Technology Alliances, Centers of Excellence, and the University Affiliated Research Centers. Partners with academia, entertainment and gaming industries to leverage innovation research and concepts for training and design.
Radar Resonant Enhanced Multi-Photo Ionization	Designing more efficient high-speed vehicles by better understanding hypersonic flows.
Applied Research Systematic study to understand the means to meet a recognized specific national security requirement. Systematic application of knowledge to develop useful materials, devices, and system or methods.	
Major Program Areas	Outcomes
Materials Technology	Matures materials technology for armor and armaments lethality and survivability capabilities to be fielded in the Future Combat Systems and Future Force systems. Provides the technology base required for solving materials-related problems in individual Soldier support equipment, armor, armaments, aircraft, ground and combat vehicles and combat support.
Combat Vehicle and Automotive Technology	Improves survivability, mobility, sustainability, and maintainability of Army ground vehicles. Supports transformation goals by reducing reliance on heavy passive armor using a layered approach, substituting long-rang situational awareness, multi-spectral signature reduction, active protection systems and advanced lightweight armor.
Nanorobot Fabrication Makes Ultrasmall Sensors Possible	Leverages nano technology to enhance surveillance capabilities using infrared cameras small enough to fit into mini-unmanned aerial vehicles.
Free-Electron Laser Being Developed For Shipboard Defense	Provides shipboard defense against enemy threats from missiles to small fishing boats. The strength of the laser may also be useful for penetrating the ground to aid in detecting improvised explosive devices and land mines.
Commander's Predictive Environment	Create capabilities that will enable commanders to anticipate and shape battlespace. Anticipate the strengths, capabilities and vulnerabilities of adversaries.
Hard Target Defeat	Develop tunnel and hard target attack technologies, including testing advanced energetic materials, using new explosive mixtures in penetrating warheads.

Department of Defense Investments in Research and Development	
Development Takes what has been discovered or learned from basic and applied research and uses it to establish: technological feasibility, assessment of operability, and production capability. Development is comprised of five stages: advanced technology, development, advanced component development and prototypes, system development and demonstration; management support, and operational systems development.	
Major Program Areas	Outcomes
Test Ranges and Facilities and Research, Development, Test and Evaluation Management Support	Sustains the Department's required developmental test and evaluation capability and operates the developmental test activities required by weapons systems developers. Operates White Sands Missile Range (NM), Aberdeen Test Center (MD), Yuma Proving Ground (AZ), Aviation Technical Test Center (AL), Redstone Arsenal (AL), and Electronic Proving Ground (AZ) Supports research and development efforts and includes test ranges, military construction, maintenance support of laboratories, and operations and maintenance of test aircraft and ships. Funds the planning, improvements and modernization for three national asset test centers. Two efforts utilizing these unique test capabilities are the Propulsion Wind Tunnel Upgrade at Arnold Engineering Development Center and the Threat Simulator Development/Low Radar Cross Section threat modeling and simulation Provides resources for test planning and safety verification and confirmation. Achieved successful launches of military satellites, utilizing Titan, and Atlas and Delta. Develops the Family of Advanced Beyond Line of Sight Terminals to provide robust, secure, strategic and tactical global communications for nuclear and conventional forces.
Electronic Warfare Advanced Technology	Provides technologies for a secure, mobile, wireless network that operates in diverse and complex terrain. Also matures: Protection technologies for tactical wireless networks Smart communication technologies to enable network and control of unmanned systems shortening the sensor-decider-engagement time to defeat critical targets.
Advanced Tank Armament System	Improves the deploy ability and operational effectiveness of rapid response/early entry forces. Leverages common platform/common chassis design which reduces requirements for repair parts and logistics support in the area of operations.
Multiple Launch Rocket System Product Improvement Program	Supports improvements to High Mobility Artillery Rocket System, Guided Multiple Launch Rocket System and Unitary munition which provide precision strike capability.
Plumbing the Chemistry of Iraq Improvised Explosive Devices	Analyzing molecular interaction of explosive materials to study the physics and chemistry of improvised explosive devices and to find techniques to detonate or short circuit the devices before causing harm.
Assured Fuel Initiative	Developing new fuel alternatives based on mixtures of conventional fuel, natural gas and coal to power jets.
Air Defense Command, Control and Intelligence -- Engineering Development	Integrates Air and Missile Defense operations. Provides continuously tailored situational awareness and situational understanding of the battle space.

Required Supplementary Information

Heritage Assets

Department Of Defense Consolidated Heritage Assets For Fiscal Year Ended September 30, 2006					
Categories	Unit of Measure	As of 10/01/05	Additions	Deletions	As of 9/30/06
Museums	Each	241		138	103
Monuments and Memorials	Each	2,010	12		2,022
Cemeteries	Sites	565	6		571
Archeological Sites	Sites	93,906	4,005		97,911
Buildings and Structures	Each	25,311		1,867	23,444
Major Collections	Each	90	20		110

Heritage Assets are real and personal property with importance at the national level due to their significant historical, natural, cultural, educational, artistic, architectural, or, aesthetic value. Heritage Assets can include museums and/or their collections, art and other collections, archival records, cemeteries, monuments and memorials, and archeological sites.

Establishing items as having heritage significance varies among categories and type of assets. Subject matter experts, criteria such as listing on the National Register of Historic Places, and Federal laws, all play a significant role in characterizing these assets.

The fiscal year 2006 categories are defined as follows:

Museums. Buildings that house collection-type items including artwork, archeological artifacts, archival materials, and other historical artifacts. The primary use of such buildings is the preservation, maintenance and display of collection-type Heritage Assets.

Monuments and Memorials. Sites and structures built to honor and preserve the memory of significant individuals and/or events in history.

Cemeteries. Land on which gravesites of prominent historical figures or honored individuals are located.

Archeological Sites. Land on which items of archeological significance are located.

Buildings and Structures. Includes buildings and structures that are listed on, or are eligible for listing on, the National Register of Historic Places, including Multi-Use Heritage Assets. These buildings do not include museums.

Major Collections. Significant collections that are maintained outside of a museum.

Stewardship Land

Department Of Defense Consolidated Stewardship Land For Fiscal Year Ended September 30, 2006 (Acres In Thousands)				
Land Use	As of 10/01/05	Additions	Deletions	As of 9/30/06
Mission	16,669	--	654	16,015
Parks and Historic Sites	1	--	--	1
Total	16,700			16,016

Stewardship Land is land that is not acquired for, or in connection with, items of General Property, Plant and Equipment. All land, regardless of its use, provided to the Department from the Public Domain, or at no cost, is classified as Stewardship Land. Stewardship Land is reported in physical units (acres) rather than cost or fair value.

Deferred Maintenance of Real Property

Sustainment is the maintenance and repair activities necessary to keep the Department's real property (buildings, structures, and utilities) in good working order. It includes regularly scheduled adjustments and inspections, preventive maintenance tasks, and emergency response and service calls for minor repairs. It also includes major repairs or replacement of facility components (usually accomplished by contract) that are expected to occur periodically throughout the life cycle of facilities. This work includes regular roof replacement, refinishing of wall surfaces, repairing and replacement of heating and cooling systems, replacing tile and carpeting, and similar types of work. It does not include environmental compliance costs, facility leases, or other tasks associated with facilities operations (such as custodial services, grounds services, waste disposal, and the provision of central utilities). The Department's fiscal year 2006 sustainment requirements were $7.5 billion and it received $6.5 billion to fund these requirements leaving a deferred sustainment requirement of $1.0 billion this year. The Department's deferred sustainment trend for the past several years is summarized below:

Annual Deferred Sustainment Trend ($Millions)						
Property Type	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006
Buildings, Structures, and Utilities	$2,036	$1,762	$1,555	$2,127	$1,876	$984

Restoration is returning the Department's real property (buildings, structures, and utilities) to such a condition that it may be used for its designated purpose. Restoration includes repair or replacement work to restore facilities damaged by inadequate sustainment, excessive age, natural disaster, fire, accident, or other causes. Modernization is the alteration or replacement of facilities solely to implement new or higher standards, to accommodate new functions, or to replace building components that typically last more than 50 years (such as the framework or foundation).

Beginning in fiscal year 2005, the Department began transitioning to a more consistent and verifiable methodology to assess the total restoration and modernization requirements by using a standardized Department-wide quality rating system to replace the former Military Service-defined condition ratings. Until a standardized methodology is in place, the Department is unable to report its restoration and modernization requirements. The Department Component's financial statements contain detailed information on the restoration and modernization estimates.

The United States Army Corps of Engineers reports $1.8 million of deferred maintenance for water resources projects. This amount is not included in the table above. It is reported separately due to the nature of the projects and the different methodology used to calculate the amount reported.

Deferred Maintenance of Military Equipment

Depot maintenance requirements for military equipment are developed during the annual budget process. The depot maintenance requirements for individual items are determined by considering numerous factors. Analysis factors include: changes in the fleet size or in-use inventory; the date of last overhaul or operating hours since last overhaul; the current maintenance engineering plan expressed as a time interval or as an operational factor; and the planned operating tempo expressed in miles, flying hours, or steaming hours. The depot maintenance cost for each major program is determined using costing models. Fiscal constraints determine requirements that are funded. The deferred maintenance numbers reported in the table below reflect the difference. The Department Components' financial statements contain detailed information on each program.

Military Equipment Type	*Deferred Maintenance (Amounts in millions)*
Aircraft	$290.9
Engines	25.8
Software	97.0
Other Major End Items	4.2
Ships	26.0
Missiles	233.5
Combat Vehicles	382.4
Other Weapon Systems	533.2
Total	**$1,593.0**

Statement of Disaggregated Budgetary Resources

Department of Defense
STATEMENT OF DISAGGREGATED BUDGETARY RESOURCES
For the Years Ended September 30, 2006 and 2005
($ in Millions)

	Military Retirement Fund	Other	Research, Development, Test & Evaluation
BUDGETARY FINANCING ACCOUNTS			
Budgetary Resources			
Unobligated balance, brought forward, October 1	$ 97.2	$ 9,528.1	$ 9,924.9
Recoveries of prior year unpaid obligations	0.0	416.3	2,698.8
Budget authority			
Appropriation	83,655.0	62,205.3	69,379.9
Borrowing authority	0.0	0.0	0.0
Contract authority	0.0	372.9	0.1
Spending authority from offsetting collections			
Earned			
Collected	0.0	2,175.5	8,364.8
Change in receivables from Federal sources	0.0	28.7	(274.3)
Change in unfilled customer orders			
Advance received	0.0	14.7	(46.9)
Without advance from Federal sources	0.0	(1.3)	704.5
Subtotal	83,655.0	64,795.8	78,128.1
Nonexpenditure transfers, net, anticipated and actual	0.0	(8,405.3)	942.0
Temporarily not available pursuant to Public Law	(35,442.9)	(293.4)	0.0
Permanently not available	0.0	(404.1)	(1,404.0)
Total Budgetary Resources	$ 48,309.3	$ 65,637.4	$ 90,289.8
Status of Budgetary Resources			
Obligations incurred:			
Direct	$ 48,309.3	$ 55,775.1	$ 69,234.8
Reimbursable	0.0	1,381.5	8,805.2
Subtotal	48,309.3	57,156.6	78,040.0
Unobligated balance:			
Apportioned	0.0	6,066.7	11,459.1
Exempt from apportionment	0.0	724.0	0.0
Subtotal	0.0	6,790.7	11,459.1
Unobligated balance not available	0.0	1,690.1	790.7
Total Status of Budgetary Resources	$ 48,309.3	$ 65,637.4	$ 90,289.8
Change in Obligated Balance			
Obligated balance, net			
Unpaid obligations, brought forward, October 1	$ 3,709.0	$ 6,709.8	$ 33,995.6
Less: Uncollected customer payments from Federal sources, brought forward, October 1	0.0	(117.0)	(5,336.3)
Total unpaid obligated balance	3,709.0	6,592.8	28,659.3
Obligations incurred net	48,309.3	57,156.6	78,040.0
Less: Gross outlays	(48,211.3)	(54,419.7)	(73,069.0)
Obligated balance transferred, net:			
Actual transfers, unpaid obligations	0.0	0.0	0.0
Actual transfers, uncollected customer payments from Federal sources	0.0	0.0	0.0
Total Unpaid obligated balance transferred, net	0.0	0.0	0.0
Less: Recoveries of prior year unpaid obligations, actual	0.0	(416.3)	(2,698.8)
Change in uncollected customer payments from Federal sources	0.0	(27.0)	(430.3)
Obligated balance, net, end of period:			
Unpaid obligations	3,807.0	9,030.4	36,267.8
Less: Uncollected customer payments from Federal sources	0.0	(144.0)	(5,766.6)
Total, unpaid obligated balance, net, end of period	3,807.0	8,886.4	30,501.2
Net Outlays:			
Gross outlays	$ 48,211.3	$ 54,419.7	$ 73,069.0
Less: Offsetting collections	0.0	(2,190.2)	(8,317.9)
Less: Distributed Offsetting receipts	(57,326.7)	(2,608.3)	0.0
Net Outlays	$ (9,115.4)	$ 49,621.2	$ 64,751.1

Department of Defense
STATEMENT OF DISAGGREGATED BUDGETARY RESOURCES
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($ in Millions)

	Civil Works	Operation and Maintenance	Procurement
BUDGETARY FINANCING ACCOUNTS			
Budgetary Resources			
Unobligated balance, brought forward, October 1	$ 5,003.2	$ 7,788.4	$ 25,206.4
Recoveries of prior year unpaid obligations	0.0	16,383.9	3,937.2
Budget authority			
Appropriation	12,439.7	211,473.2	103,401.6
Borrowing authority	0.0	0.0	0.0
Contract authority	0.0	(0.1)	0.0
Spending authority from offsetting collections			
Earned			
Collected	9,407.1	26,302.8	2,796.7
Change in receivables from Federal sources	1,690.7	(641.7)	(92.4)
Change in unfilled customer orders			
Advance received	22.7	47.2	33.6
Without advance from Federal sources	(719.5)	(6.3)	31.1
Subtotal	22,840.7	237,175.1	106,170.6
Nonexpenditure transfers, net, anticipated and actual	(8.1)	3,205.7	3,299.4
Temporarily not available pursuant to Public Law	(10.0)	0.0	0.0
Permanently not available	(54.5)	(3,944.1)	(2,704.6)
Total Budgetary Resources	$ 27,771.3	$ 260,609.0	$ 135,909.0
Status of Budgetary Resources			
Obligations incurred:			
Direct	$ 6,902.3	$ 225,864.2	$ 100,135.7
Reimbursable	11,500.7	25,193.7	2,951.8
Subtotal	18,403.0	251,057.9	103,087.5
Unobligated balance:			
Apportioned	8,621.4	3,817.1	31,779.6
Exempt from apportionment	746.8	0.0	0.0
Subtotal	9,368.2	3,817.1	31,779.6
Unobligated balance not available	0.1	5,734.0	1,041.9
Total Status of Budgetary Resources	$ 27,771.3	$ 260,609.0	$ 135,909.0
Change in Obligated Balance			
Obligated balance, net			
Unpaid obligations, brought forward, October 1	$ 3,945.4	$ 86,482.8	$ 97,411.4
Less: Uncollected customer payments from Federal sources, brought forward, October 1	(5,450.0)	(11,294.6)	(2,664.1)
Total unpaid obligated balance	(1,504.6)	75,188.2	94,747.3
Obligations incurred net	18,403.0	251,057.9	103,087.5
Less: Gross outlays	(16,870.3)	(229,372.1)	(92,351.7)
Obligated balance transferred, net:			
Actual transfers, unpaid obligations	0.0	0.0	0.0
Actual transfers, uncollected customer payments from Federal sources	0.0	0.0	0.0
Total Unpaid obligated balance transferred, net	0.0	0.0	0.0
Less: Recoveries of prior year unpaid obligations, actual	0.0	(16,383.9)	(3,937.2)
Change in uncollected customer payments from Federal sources	(971.2)	648.0	61.3
Obligated balance, net, end of period:			
Unpaid obligations	5,478.1	91,784.7	104,210.0
Less: Uncollected customer payments from Federal sources	(6,421.2)	(10,646.6)	(2,602.8)
Total, unpaid obligated balance, net, end of period	(943.1)	81,138.1	101,607.2
Net Outlays:			
Gross outlays	$ 16,870.3	$ 229,372.1	$ 92,351.7
Less: Offsetting collections	(9,429.8)	(26,350.0)	(2,830.4)
Less: Distributed Offsetting receipts	(1,906.6)	(136.6)	0.0
Net Outlays	$ 5,533.9	$ 202,885.5	$ 89,521.3

Department of Defense
STATEMENT OF DISAGGREGATED BUDGETARY RESOURCES
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	Military Personnel	Military Construction/Family Housing	Working Capital Funds
BUDGETARY FINANCING ACCOUNTS			
Budgetary Resources			
Unobligated balance, brought forward, October 1	$ 899.9	$ 5,705.6	$ 4,435.8
Recoveries of prior year unpaid obligations	4,045.7	779.6	1,980.7
Budget authority			
Appropriation	124,884.7	10,046.8	4,196.5
Borrowing authority	0.0	0.0	0.0
Contract authority	0.0	0.0	59,078.8
Spending authority from offsetting collections			
Earned			
Collected	1,012.6	4,625.6	110,032.4
Change in receivables from Federal sources	(209.0)	(78.1)	225.1
Change in unfilled customer orders			
Advance received	0.0	321.1	(78.5)
Without advance from Federal sources	(6.1)	664.9	(488.2)
Subtotal	125,682.2	15,580.3	172,966.1
Nonexpenditure transfers, net, anticipated and actual	2,804.3	(433.6)	(1,586.6)
Temporarily not available pursuant to Public Law	0.0	0.0	0.0
Permanently not available	(1,393.4)	(533.3)	(61,416.5)
Total Budgetary Resources	$ 132,038.7	$ 21,098.6	$ 116,379.5
Status of Budgetary Resources			
Obligations incurred:			
Direct	$ 130,216.5	$ 8,802.3	$ 1,191.8
Reimbursable	922.1	5,288.4	109,477.9
Subtotal	131,138.6	14,090.7	110,669.7
Unobligated balance:			
Apportioned	206.7	6,881.7	5,790.0
Exempt from apportionment	0.0	0.0	(250.4)
Subtotal	206.7	6,881.7	5,539.6
Unobligated balance not available	693.4	126.2	170.2
Total Status of Budgetary Resources	$ 132,038.7	$ 21,098.6	$ 116,379.5
Change in Obligated Balance			
Obligated balance, net			
Unpaid obligations, brought forward, October 1	$ 2,745.5	$ 13,080.9	$ 52,365.1
Less: Uncollected customer payments from Federal sources, brought forward, October 1	(192.1)	(5,009.8)	(24,523.0)
Total unpaid obligated balance	2,553.4	8,071.1	27,842.1
Obligations incurred net	131,138.6	14,090.7	110,669.7
Less: Gross outlays	(126,210.3)	(11,345.3)	(111,777.7)
Obligated balance transferred, net:			
Actual transfers, unpaid obligations	0.0	0.0	0.0
Actual transfers, uncollected customer payments from Federal sources	0.0	0.0	0.0
Total Unpaid obligated balance transferred, net	0.0	0.0	0.0
Less: Recoveries of prior year unpaid obligations, actual	(4,045.7)	(779.6)	(1,980.7)
Change in uncollected customer payments from Federal sources	215.1	(586.8)	263.1
Obligated balance, net, end of period:			
Unpaid obligations	3,628.1	15,046.7	49,276.4
Less: Uncollected customer payments from Federal sources	23.0	(5,596.6)	(24,259.9)
Total, unpaid obligated balance, net, end of period	3,651.0	9,450.1	25,016.4
Net Outlays:			
Gross outlays	$ 126,210.3	$ 11,345.3	$ 111,777.7
Less: Offsetting collections	(1,012.6)	(4,946.7)	(109,953.9)
Less: Distributed Offsetting receipts	0.0	0.0	0.0
Net Outlays	$ 125,197.7	$ 6,398.6	$ 1,823.8

Department of Defense
STATEMENT OF DISAGGREGATED BUDGETARY RESOURCES
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($ in Millions)

		2006 Combined		2005 Combined
BUDGETARY FINANCING ACCOUNTS				
Budgetary Resources				
Unobligated balance, brought forward, October 1	$	68,589.5	$	73,282.9
Recoveries of prior year unpaid obligations		30,242.2		36,376.7
Budget authority				
Appropriation		681,682.7		604,969.5
Borrowing authority		0.0		0.0
Contract authority		59,451.7		56,753.1
Spending authority from offsetting collections				
Earned				
Collected		164,717.5		158,928.0
Change in receivables from Federal sources		649.0		(18.2)
Change in unfilled customer orders				
Advance received		313.9		642.0
Without advance from Federal sources		179.1		5,065.9
Subtotal		906,993.9		826,340.3
Nonexpenditure transfers, net, anticipated and actual		(182.2)		264.5
Temporarily not available pursuant to Public Law		(35,746.3)		(31,875.4)
Permanently not available		(71,854.5)		(58,299.7)
Total Budgetary Resources	$	898,042.6	$	846,089.3
Status of Budgetary Resources				
Obligations incurred:				
Direct	$	646,432.0	$	601,516.8
Reimbursable		165,521.3		175,983.1
Subtotal		811,953.3		777,499.9
Unobligated balance:				
Apportioned		74,622.3		59,206.9
Exempt from apportionment		1,220.4		725.9
Subtotal		75,842.7		59,932.8
Unobligated balance not available		10,246.6		8,656.6
Total Status of Budgetary Resources	$	898,042.6	$	846,089.3
Change in Obligated Balance				
Obligated balance, net				
Unpaid obligations, brought forward, October 1	$	300,445.5	$	282,772.9
Less: Uncollected customer payments from Federal sources, brought forward, October 1		(54,586.9)		(49,538.8)
Total unpaid obligated balance		245,858.6		233,234.1
Obligations incurred net		811,953.3		777,499.9
Less: Gross outlays		(763,627.4)		(723,450.6)
Obligated balance transferred, net:				
Actual transfers, unpaid obligations		0.0		0.0
Actual transfers, uncollected customer payments from Federal sources		0.0		0.0
Total Unpaid obligated balance transferred, net		0.0		0.0
Less: Recoveries of prior year unpaid obligations, actual		(30,242.2)		(36,376.7)
Change in uncollected customer payments from Federal sources		(827.8)		(5,048.0)
Obligated balance, net, end of period:				
Unpaid obligations		318,529.2		300,445.5
Less: Uncollected customer payments from Federal sources		(55,414.7)		(54,586.9)
Total, unpaid obligated balance, net, end of period		263,114.5		245,858.6
Net Outlays:				
Gross outlays	$	763,627.4	$	723,450.6
Less: Offsetting collections		(165,031.5)		(159,570.1)
Less: Distributed Offsetting receipts		(61,978.2)		(55,072.9)
Net Outlays	$	536,617.7	$	508,807.6

Department of Defense
STATEMENT OF DISAGGREGATED BUDGETARY RESOURCES
For the Years Ended September 30, 2006 and 2005
($ in Millions)

	Other	2006 Combined	2005 Combined
NONBUDGETARY FINANCING ACCOUNTS			
Budgetary Resources			
Unobligated balance, brought forward, October 1	$ 35.0	$ 35.0	$ 24.6
Recoveries of prior year unpaid obligations	0.0	0.0	0.0
Budget authority			
Appropriation	0.0	0.0	0.0
Borrowing authority	93.8	93.8	170.3
Contract authority	0.0	0.0	0.0
Spending authority from offsetting collections			
Earned			
Collected	58.5	58.5	16.9
Change in receivables from Federal sources	0.0	0.0	0.0
Change in unfilled customer orders			
Advance received	0.0	0.0	0.0
Without advance from Federal sources	(46.8)	(46.8)	40.6
Subtotal	105.5	105.5	227.8
Nonexpenditure transfers, net, anticipated and actual	0.0	0.0	0.0
Temporarily not available pursuant to Public Law	0.0	0.0	0.0
Permanently not available	(0.1)	(0.1)	(2.2)
Total Budgetary Resources	$ 140.4	$ 140.4	$ 250.2
Status of Budgetary Resources			
Obligations incurred:			
Direct	$ 108.9	$ 108.9	$ 215.2
Reimbursable	0.0	0.0	0.0
Subtotal	108.9	108.9	215.2
Unobligated balance:			
Apportioned	0.5	0.5	1.5
Exempt from apportionment	0.0	0.0	0.0
Subtotal	0.5	0.5	1.5
Unobligated balance not available	31.0	31.0	33.5
Total Status of Budgetary Resources	$ 140.4	$ 140.4	$ 250.2
Change in Obligated Balance			
Obligated balance, net			
Unpaid obligations, brought forward, October 1	$ 446.3	$ 446.3	$ 238.8
Less: Uncollected customer payments from Federal sources, brought forward, October 1	(123.7)	(123.7)	(83.1)
Total unpaid obligated balance	322.6	322.6	155.7
Obligations incurred net	108.9	108.9	215.2
Less: Gross outlays	(176.8)	(176.8)	(7.7)
Obligated balance transferred, net:			
Actual transfers, unpaid obligations	0.0	0.0	0.0
Actual transfers, uncollected customer payments from Federal sources	0.0	0.0	0.0
Total Unpaid obligated balance transferred, net	0.0	0.0	0.0
Less: Recoveries of prior year unpaid obligations, actual	0.0	0.0	0.0
Change in uncollected customer payments from Federal sources	46.8	46.8	(40.6)
Obligated balance, net, end of period:			
Unpaid obligations	378.5	378.5	446.3
Less: Uncollected customer payments from Federal sources	(76.9)	(76.9)	(123.7)
Total, unpaid obligated balance, net, end of period	301.6	301.6	322.6
Net Outlays:			
Gross outlays	$ 176.8	$ 176.8	$ 7.7
Less: Offsetting collections	(58.5)	(58.5)	(16.9)
Less: Distributed Offsetting receipts	0.0	0.0	0.0
Net Outlays	$ 118.3	$ 118.3	$ (9.2)

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Section 4:
Other Accompanying Information

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Management Assurance Details

A summary of the Department's management assurances over internal management controls for the Federal Managers' Financial Integrity Act as required by Office of Management and Budget Circular A-123, Management's Responsibility for Internal Control, is included in Section 1: Management's Discussion and Analysis. The details for these assurances are included below.

The Department classifies internal management control weaknesses into four categories: The following six tables list the weaknesses grouped as follows:

1. ***Section 2 Overall Material Weaknesses:*** Weaknesses materially affecting internal management controls that warrant reporting to a higher level and usually affect a single Department component. Includes overall material weaknesses for all functions except financial reporting weaknesses. Includes some financial weaknesses identified through self assessments which were not included in the Department's statement of assurance over financial reporting under the oversight of the Department Senior Assessment Team.
2. ***Section 2 Overall Systemic Weaknesses:*** Weaknesses materially affecting internal management controls across organizational and program lines and usually affecting multiple Department components. Includes overall systemic weaknesses for all functions except financial reporting weaknesses. Includes some financial weaknesses identified through self assessments which were not included in the Department's statement of assurance over financial reporting under the oversight of the Department's Senior Assessment Team.
3. ***Section 4 System Nonconformance Weaknesses:*** System nonconformance with government-wide requirements such as the Federal Financial Management Improvement Act as prescribed by the Office of Management and Budget Circular A-127, Financial Management Systems.
4. ***Section 2 Financial Reporting Weaknesses:*** Weaknesses materially affecting the Department's financial reporting found during the assessment of internal controls over financial reporting conducted in compliance with the Office of Management and Budget Circular A-123, Appendix A, for the areas covered in the FY 2006 assessment review to include: investments, real property, military equipment, Federal Employee Compensation Act Liabilities, environmental liabilities, Medicare-Eligible Retiree Health Care Liabilities, appropriations received. Also a limited review occurred for fund balance with Treasury.

The following six tables list the weaknesses grouped as follows:

Table I, Section 2 Corrected Financial and Non-Financial Material Weaknesses lists seven corrected during this fiscal year.

Table II, Section 2 Financial Material Weaknesses Consolidated with Other Similar Weaknesses lists four financial material weaknesses that were consolidated into similar systemic weaknesses.

Tables IIIa and IIIb, Section 2 Overall Financial and Non-Financial Material Weaknesses – Ongoing list the 18 ongoing material weaknesses. Four are financial issues of which one is being newly identified. Fourteen are related to non-financial issues of which six were newly identified this fiscal year. For these material weaknesses, a sample of the corrective actions was selected for reporting. The status dates for FYs 2005 and 2006 are displayed to show any progress in completing the weakness as projected.

Table IV, Section 2 Overall Systemic Weaknesses – Ongoing lists the eleven systemic weaknesses that are outstanding at the end of FY 2006.

Table V, Section 4 System Nonconformance Weaknesses – Ongoing lists one ongoing Section 4 system nonconformance material weakness.

Table VI, Section 2 Financial Reporting Weaknesses lists five outstanding weaknesses as of the end of FY 2006.

Table I. Section 2 Corrected Overall Material Weaknesses

Non-Financial Material Weaknesses	Major Corrective Action(s) A sample of the actions is presented.	Status Date as Reported in FY05	Status Date as Reported in FY06
1. The Defense Logistics Agency's accounts receivable and accounts payable were reduced to acceptable levels. (Defense Logistics Agency) First Reported: FY 2002	- Issued standard guidance and procedures for managing accounts receivables and payables.	Completed	Completed
	- Collected, wrote-off, or closed-out supportable and valid accounts receivables over 2 years old except for certain categories.	Completed	Completed
	- Implemented a plan to liquidate valid over aged accounts payable and write-off invalid payables.	Completed	Completed
	- Validated that the weakness is corrected. Completed	1st Qtr 06	Completed
2. The Department of Army has favorably resolved an issue for processing the line of duty and incapacitation pay, that adversely affected reservists who attempted to receive benefits after their duty obligation was met. (Department of the Army) First Reported: FY 2002	- Developed policies and procedures.	Completed	Completed
	- Conducted legal review of the regulation changes.	Completed	Completed
	- Published the regulatory guidance.	Completed	Completed
	- Conducted audit review to validate the effectiveness of corrective actions. Completed	1st Qtr 06	Completed
3. The Defense Threat Reduction Agency has resolved an issue where the Russian Federation failed to honor its commitments associated with the Cooperative Threat Reduction Program. (Defense Threat Reduction Agency) First Reported: FY 2002	- The Russian Federation signed the amendments for storage security, weapons transportation security, and chemical weapon elimination.	Completed	Completed
	- Worked with the Russian Federation to ensure plans are prepared for further reduction on nerve agents.	1st Qtr 06	Completed
	- Validated that the weakness is corrected. Completed	1st Qtr 06	Completed
4. The Counter Intelligence Activity has reduced to a level of non-materiality instances where planning for periods of crisis were not fully developed. (Office of the Under Secretary of Defense, (Intelligence) Counter-Intelligence Field Activity) First Reported: FY 2005	- Developed and implemented a plan.	2nd Qtr 06	Completed
	- Conducted training.	3nd Qtr 06	Completed
	- Validated that the weakness is corrected. Completed	3nd Qtr 06	Completed

Table I. Section 2 Corrected Overall Material Weaknesses

Non-Financial Material Weaknesses	Major Corrective Action(s) A sample of the actions is presented.	Status Date as Reported in FY05	Status Date as Reported in FY06
5. The National Defense University has resolved issues where contractors are not always appropriately identifying themselves according to the Federal Acquisition Regulation. (National Defense University) First Reported: FY 2005	- Developed remedial training for contractors.	Completed	Completed
	- Standardized e-mail procedures for contractors.	Completed	Completed
	- Established proper identification.	2nd Qtr 06	Completed
	- Validated that the weakness is corrected. Completed	2nd Qtr 06	Completed
6. The Department of the Army has resolved processes for managing workload, linking workload to dollars required, and predicting future manpower requirements have not been established. (Department of the Army) First Reported: FY 1997	- Validated the missions. Refined the linkage between operating and generating forces.	Completed	Completed
	- Analyzed workload for peacetime and wartime. Linked the workload to the operating force.	Completed	Completed
	- Ensured that there is accurate documentation to validate the manpower requirements in the official record called the "Table of Distribution and Allowances."	Completed	Completed
	- Issued a change to the regulation on the approval authority for manpower requirement determinations.	Completed	Completed
	- Completed audit review to validate that the weakness is corrected. Completed	1st Qtr 06	Completed
7. The Office of the Under Secretary of Defense (Intelligence) has resolved the issue where skill sets to support critical missions were not adequate. First Reported: FY 2005	- Identified the requirement for manpower.	Completed	Completed
	- Developed supporting documentation.	Completed	Completed
	- Obtained senior level approval.	3rd Qtr 06	Completed
	- Validated that the weakness is corrected. Completed	4th Qtr 06	Completed

Table II. Section 2 Consolidated Overall Material Weaknesses

Financial Material Weaknesses	Major Corrective Action(s) A sample of the actions is presented.	Status Date as Reported in FY05	Status Date as Reported in FY06
1. Instances where an ineffective process prevents ensuring that disbursements and collections by service providers are properly recorded. (Defense Intelligence Agency) First Reported: FY 2005	- Established adequate staffing.	Completed	Completed
	- Establish a baseline for reconciliation.	4th Qtr 06	4th Qtr 07
	- Reconcile the Fund Balance with Treasury account.	1st Qtr 07	1st Qtr 09
	- Validate that the weakness is corrected. Consolidated into Financial Reporting Weakness #5 at Table VI	4th Qtr 07	4th Qtr 09

Table II. Section 2 Consolidated Overall Material Weaknesses			
Financial Material Weaknesses	Major Corrective Action(s) A sample of the actions is presented.	Status Date as Reported in FY05	Status Date as Reported in FY06
2. The Fund Balance with Treasury accounts for the Defense Agencies and Navy cannot always be accurately reconciled. (Defense Finance and Accounting Service)	- Developed a plan and milestones that address controls, reconciliation, and assertion that the accounts are ready to audit.	1st Qtr 06	Completed
	- Implemented full operational capability of financial system (Columbus Cash Accountability System).	2nd Qtr 06	Completed
	- Reconciled disbursements.	3rd Qtr 06	Completed
	- Modified business procedures to eliminate incorrect subheads on transactions.	4th Qtr 06	Completed
	- Perform validation of identified actions for selected Defense Agencies.	1st Qtr 07	2nd Qtr 07
First Reported: FY 2005	- Validate that the weakness is corrected. Consolidated into Financial Reporting Weakness #5 at Table VI.	3rd Qtr 07	3rd Qtr 07
3. Accounts Payable were not always accurately recorded in a timely manner. (Department of the Navy)	- Defined scope and created plan to correct problem.	Completed	Completed
	- Conducted training.	1st Qtr 06	Completed
	- Collected requirements to modify the workflow process.	2nd Qtr 06	Completed
	- Modify the workflow and systems to accurately record accounts payable.	1st Qtr 07	4th Qtr 09
	- Ensure that corrective actions are working.	3rd Qtr 07	1st Qtr 10
	- Assert that the account is ready to audit.	1st Qtr 08	3rd Qtr 10
First Reported: FY 2005	- Conduct audit to validate that the weakness is corrected. Consolidated into Overall Systemic Weakness #11 at Table IV.	2nd Qtr 08	1st Qtr 11
4. The accounts payable do not always accurately reflect the liabilities associated with the actual receipt of goods and services in the appropriate time period. (Defense Finance Accounting Service)	- Reviewed current business practices.	Completed	Completed
	- Established a plan of actions.	Completed	Completed
	- Implemented metrics to measure magnitude of problem and impact of corrective actions.	2nd Qtr 06	Completed
	- Certify and implement procedures for capturing and reporting accounts payable.	-	2nd Qtr 07
	- Cleanup accounting systems at the transaction level.	-	3rd Qtr 08
First Reported: FY 2004	- Validate that the weakness is corrected. Consolidated into Overall Systemic Weakness #11 at Table IV.	1st Qtr 07	4th Qtr 08

Table IIIa. Section 2 Overall Financial Material Weaknesses - Ongoing			
Financial Material Weaknesses	Major Corrective Action(s) A sample of the actions is presented.	Status Date as Reported in FY05	Status Date as Reported in FY06
1. Adequate documentation does not always exist to support adjustments used to reconcile general ledger data to budgetary data. (Defense Finance & Accounting Service)	- Built crosswalks from the legacy line of accounting to the standard fiscal code to the Defense Departmental Reporting System-Budgetary.	Completed	Completed
	- Implemented and validated a crosswalk process to map transactions to the appropriate general ledger accounts.	Completed	Completed
	- Activated the Defense Departmental Reporting System-Budgetary.	Completed	Completed
	- Implement the Defense Departmental Reporting System-Budgetary.	-	1st Qtr 07
	- Begin reporting exclusively through the Defense Departmental Reporting System-Budgetary		2nd Qtr 07
First Reported: FY 2003	- Validate that the weakness is corrected Revised Correction Target Date: 3rd Qtr, FY 2007	2nd Qtr 06	3rd Qtr 07
2. Policy for recording, reporting, collecting and reconciling accounts receivable from public and government sources is not always followed. (Defense Finance & Accounting Service)	- Monitored monthly and performed quarterly reconciliation.	Completed	Completed
	- Conducted random review of compliance to policy and procedures.	2nd Qtr 06	Completed
	- Published standard accounts receivable operating procedures for Department.	4th Qtr 06	Completed
	- Validate the accounting events in the accounting systems.	-	2nd Qtr 07
First Reported: FY 2003	- Provide assertion that accounts receivables are ready for audit and validate that the weakness is corrected. Revised Correction Target Date: 4th Qtr, FY 2007	2nd Qtr 07	4th Qtr 07
3. Lack of controls to accurately reconcile obligation of the foreign military sales with budgetary authority. (Department of the Air Force)	- Identified scope of project.	-	Completed
	- Complete the accounting reconciliation and reprioritize workload.	-	3rd Qtr 07
	- Implement reprogramming changes recommended by the working group.	-	1st Qtr 08
First Reported: FY 2006	- Validate that the weakness is corrected. Correction Target Date: 1st Qtr, FY 2008	-	1st Qtr 08

Table IIIa. Section 2 Overall Financial Material Weaknesses - Ongoing			
Financial Material Weaknesses	Major Corrective Action(s) A sample of the actions is presented.	Status Date as Reported in FY05	Status Date as Reported in FY06
4. There are instances where unsupported adjustments are being made to the general ledger accounts. (Defense Logistics Agency)	- Launched agency-wide effort to properly establish codes and correctly use them.	Completed	Completed
	- Reviewed procedures to maintain supporting documentation.	1st Qtr 06	Completed
	- Implement procedures to perform reconciliation.	1st Qtr 06	3rd Qtr 07
	- Review and validate accounts payable.	-	2nd Qtr 08
First Reported: FY 2005	- Validate that the weakness is corrected. Revised Correction Target Date: 4th Qtr, FY 2008	4th Qtr 06	4th Qtr 08

Table IIIb. Section 2 Overall Non-Financial Material Weaknesses - Ongoing			
Non-Financial Material Weaknesses	Major Corrective Action(s) A sample of the actions is presented.	Status Date as Reported in FY05	Status Date as Reported in FY06
5. Instances where inefficiencies occurred in planning for and paying for joint training exercises due to inadequate controls. (Joint Staff)	- Issue guidance.	-	1st Qtr 07
	- Report results.	-	2nd Qtr 07
First Reported: FY 2006	- Validate that the weakness is corrected. Correction Target Date: 3rd Qtr, FY 2007	-	3rd Qtr 07
6. Inadequate controls to effectively manage pharmaceuticals. (Department of the Air Force)	- Issued policy.	Completed	Completed
	- Implemented system modifications to alert medical personnel of inappropriate procurement sources and to track backorder status.	2nd Qtr 06	Completed
	- Published procedures to manage procurement of pharmaceuticals.	3rd Qtr 06	Completed
	- Review the effectiveness of corrective actions.	3rd Qtr 07	3rd Qtr 07
First Reported: FY 2005	- Validate that the weakness is corrected. Correction Target Date: 3rd Qtr, FY 2007	3rd Qtr 07	3rd Qtr 07

Table IIIb. Section 2 Overall Non-Financial Material Weaknesses - Ongoing			
Non-Financial Material Weaknesses	Major Corrective Action(s) A sample of the actions is presented.	Status Date as Reported in FY05	Status Date as Reported in FY06
7. Inadequate controls to ensure that systems engineering plans meet technical objectives. (Missile Defense Agency)	- Completed a draft of the plan.	-	Completed
	- Coordinated plan for review.	-	Completed
	- Complete and issue plan and guidance.	-	1st Qtr 07
	- Audit the plan.	-	3rd Qtr 07
First Reported: FY 2006	- Validate that the weakness is corrected. Correction Target Date: 3rd Qtr, FY 2007	-	3rd Qtr 07
8. Instances where civilian premium payments, such as overtime pay, were not properly processed and authorized. (United States Transportation Command)	- Conducted timekeeper training on a quarterly basis.	-	Completed
	- Conducted supervisor training on a bi-annual basis.	-	Completed
	- Review policies for employee overtime and compensatory time.	-	1st Qtr 07
First Reported: FY 2006	- Validate that the weakness is corrected. Correction Target Date: 1st Qtr, FY 2007	-	1st Qtr 07
9. The Department's capital investment process for information technology does not confirm that the best investments are selected, that they deliver expected benefits, or that the final product or service delivers what the Department expects. (Defense Information Systems Agency)	- Completed the inventory of the enterprise information technology hardware and established a mechanism to maintain it.	Completed	Completed
	- Published a capital planning and investment guide that incorporates the portfolio management, enterprise architecture requirements, and information management.	1st Qtr 06	Completed
	- Ensure senior management performs oversight for selecting appropriate projects governed by Enterprise Architecture.	-	1st Qtr 07
	- Publish instruction to institutionalize the information technology portfolio management.	-	1st Qtr 07
First Reported: FY 2002	- Validate that the weakness is corrected. Revised Correction Target Date: 1st Qtr, FY 2007	1st Qtr 06	1st Qtr 07
10. Instances where programs have deviated from cost and schedule thresholds of the acquisition program baseline. (Office of the Secretary of Defense, TRICARE Management Activity)	- Established an internal configuration control board.	-	Completed
	- Received funding.	-	Completed
	- Approve proper authority.		2nd Qtr 07
First Reported: FY 2006	- Validate that the weakness is corrected. Correction Target Date: 2nd Qtr, FY 2007	-	2nd Qtr 07

Table IIIb. Section 2 Overall Non-Financial Material Weaknesses - Ongoing			
Non-Financial Material Weaknesses	Major Corrective Action(s) A sample of the actions is presented.	Status Date as Reported in FY05	Status Date as Reported in FY06
11. Inadequate controls on funds availability. (Office of the Secretary of Defense, Washington Headquarter Service) First Reported: FY 2006	- Issue guidance.	-	2nd Qtr 07
	- Reengineer processes for future operations.	-	1st Qtr 09
	- Validate that the weakness is corrected. Corrected Target Date: 1st Qtr, FY 2009	-	1st Qtr 09
12. Inadequate controls to implement a continuity planning program. (Department of the Navy) First Reported: FY 2006	- Fifty percent implementation of the continuity program according to guidance.	-	1st Qtr 07
	- Full implementation.	-	1st Qtr 07
	- Develop continuity plans.	-	3rd Qtr 07
	- Validate that the weakness is corrected. Correction Target Date: 3rd Qtr, FY 2007	-	3rd Qtr 07
13. Automated management tools are needed to ensure accountability of Reserve component personnel from home station and back home. (Department of the Army) First Reported: FY 2003	- Modified the global command and control system to allow data entry at all the mobilization stations.	Completed	Completed
	- Corrected the mobilized unit identification codes.	Completed	Completed
	- Corrected any disconnects between mobilization orders and the data entry.	Completed	Completed
	- Interfaced between the global command and control system and the mobilization deployment integration system to obtain the on-hand data.	Completed	Completed
	- Complete audit review.	2nd Qtr 06	2nd Qtr 07
	- Validate that the weakness is corrected. Revised Correction Target Date: 2nd Qtr, FY 2007	4th Qtr 06	2nd Qtr 07
14. Lack of clearly defined strategies or implementation plans has caused program inefficiencies for both the Chemical Demilitarization and the Nuclear Weapons Physical Security Programs. (Office of the Under Secretary of Defense for Acquisition, Technology and Logistics) First Reported: FY 2004	- Developed draft strategies and implement risk management plans.	Completed	Completed
	- Submitted draft strategies and plans for review and approval.	Completed	Completed
	- Completed actions required for a clearly defined strategies and implementation plans.	Completed	Completed
	- Submit final transition plan to leadership.	2nd Qtr 06	2nd Qtr 07
	- Validate that the weakness is corrected. Revised Corrected Target Date: 2nd Qtr, FY 2007	2nd Qtr 06	2nd Qtr 07

Table IIIb. Section 2 Overall Non-Financial Material Weaknesses - Ongoing			
Non-Financial Material Weaknesses	Major Corrective Action(s) A sample of the actions is presented.	Status Date as Reported in FY05	Status Date as Reported in FY06
15. Inadequate controls have caused instances of inaccurate accountability for equipment sold to foreign countries. (Defense Security Cooperation Agency)	- Set record keeping standards.	Completed	Completed
	- Developed checklists for validation.	Completed	Completed
	- Deployed automated application and conducted assessment visits.	Completed	Completed
	- Continue establishing a baseline and consolidate the data recommended by the Government Accountability Office report.	-	1st Qtr 07
First Reported: FY 2004	- Conduct final assessment visits and validate that the weakness is corrected. Revised Correction Target Date: 1st Qtr, FY 2007	4th Qtr 06	1st Qtr 07
16. Lack of policy and clear delineation of organizations and responsibilities puts the organization at risk for security violations, duplication of efforts, delays in program activities, and confusion over requirements. (Defense Security Cooperation Agency)	- Reviewed and coordinated changes to regulations.	Completed	Completed
	- Inspect and assess physical security.	-	1st Qtr 07
	- Publish handbook.	2nd Qtr 06	2nd Qtr 07
First Reported: FY 2004	- Validate that the weakness is corrected. Revised Correction Target Date: 2nd Qtr, FY 2007	2nd Qtr 06	2nd Qtr 07
17. Controls were not always adequate over exported Defense articles from initial shipment point to receipt by foreign customers. (Defense Security Cooperation Agency)	- Actively participated with interagency working groups.	Completed	Completed
	- Confirmation that the Bureau of Customs and Border Protection received adequate information on shipments.	3rd Qtr 06	Completed
	- Issue detailed documentation requirements and policy.	2nd Qtr 06	2nd Qtr 07
	- Issue policy decision on freight tracking system.	4th Qtr 06	4th Qtr 07
First Reported: FY 2004	- Validate that the weakness is corrected. Revised Correction Target Date: 4th Qtr, FY 2007	4th Qtr 06	4th Qtr 07
18. Adequate policies to mandate the appropriate proficiency in foreign languages are necessary to more adequately support the global war on terror. (Office of the Under Secretary of Defense (Personnel and Readiness))	- Obtained approval of a transformation roadmap.	Completed	Completed
	- Published revised Department Directive.	Completed	Completed
	- Publish revised Department Instruction.	3rd Qtr 06	1st Qtr 07
First Reported: FY 2004	- Validate that the weakness is corrected. Revised Correction Target Date: 1st Qtr, FY 2007	4th Qtr 06	1st Qtr 07

Table IV. Section 2 Overall Systemic Weaknesses - Ongoing

Title	1. Department of Defense Financial Management Systems and Processes
Description of Issue	The Department of Defense financial and business management systems and processes are costly to maintain and operate, not fully integrated, and do not provide information that is reliable, timely, and accurate. In addition, the Department has reported this issue as non-compliance with the Federal Financial Management Improvement Act of 1996 and as non-conformance with Section 4 of the Federal Managers Financial Integrity Act of 1982.
Progress to Date	A. Completed Milestones: • Established five core business mission areas: financial management, human resources management, weapon system lifecycle management, real property and installation lifecycle management, and materiel supply and service management. These business areas, working together, will unify the Department's business transformation efforts. • Established six initial business enterprise priorities: financial visibility, acquisition program visibility, materiel transaction visibility, personnel visibility, real property accountability, and common supplier engagement to guide the initial direction of transformation activities. • Defined six core financial capabilities in support of the financial visibility priority, and established performance measures to monitor and guide activities that led to the full development and maintenance of those capabilities. The six capabilities are: forecast, plan, program and budget; management of financial assets and liabilities; managerial accounting; funds allocation, collection, control, and disbursement; management of general ledger; and financial reporting. • Identified five initiatives to support the financial visibility priority: standard financial information structure, business enterprise information services, Defense cash accountability system, intra-governmental transaction system, and the program budget framework. The initial list of potential initiatives was narrowed to five in order to ensure adequate and appropriate focus and resource allocation is made that will yield the highest likelihood for success. Chartered the Defense Business System Management Committee to oversee transformation in the five core business mission areas. • Published Version 3.0 of the business enterprise architecture, which includes the standard financial information structure. • Published the Department's enterprise transition plan in September 2005. The enterprise transition plan will reflect the goals, objectives, and implementation strategies to create an integrated picture of the Department's business transformation. • Published in a report to Congress the first update to the enterprise transition plan on progress made in business transformation. • The business transformation agency of the Department oversees the Investment Review Boards, which as the authoritative body, reviews and decides investment priorities for all Defense business systems. These Investment Review Boards greatly enhanced the Department's ability to meet the FY 2005 Ronald W. Reagan National Defense Authorization Act to review all business system investments, at least annually, and certify as compliant the business system modernizations over $1,000,000.

Table IV. Section 2 Overall Systemic Weaknesses - Ongoing	
	B. Planned Milestones for FY 2007 and beyond: • Update the enterprise transition plan and financial improvement and audit readiness plan every 6 months to ensure the components have the most up to date guidance available in planning for business transformation, which is being continuously updated and refined. • Update the business enterprise architecture Version 3.1 and integrate it into the enterprise transition plan. • Integrate the standard financial information structure Phase 1 into the business enterprise information services to create a shared business intelligence environment. The business enterprise information services will include a corporate general ledger when the legacy accounting system transactions, which have been cross-walked to the standard financial information structure, can be recorded. The business transformation agency will work closely with the targeted accounting systems to ensure a common understanding and implement Phase 1 elements of the standard financial information structure. • Implement Phase 2 of the standard financial information structure into the framework for a statement of net cost. Phase 2 will define segments of responsibility, provide links to support the consolidation of financial statements, and provide a corporate level view of major operations and responsibility segments. • Align and integrate the program budget framework initiative with Phases 1 and 2 of the standard financial information structure to create a direct link between the Department's plans, programs, and budgets with execution and performance data. • Align the financial visibility performance measures to the strategic plan's goals and measures. • Update the business enterprise architecture to Version 4.0 and integrate it into the enterprise transition plan. Correction Target Date: 4th Qtr, FY 2015
Title	2. Management of Information Technology and Assurance
Description of Issue	The Department of Defense information systems are potentially vulnerable to an information warfare attack. In addition, the Department has reported this issue as a "significant deficiency" under the reporting requirements of the Federal Information Security Management Act.
Progress to Date	A. Completed Milestones: • Issued the Department of Defense Information Assurance Training and Certification Manual which provides guidance for identification and certification of personnel conducting information assurance functions within the Department. • Directed the Department-wide use of the public key infrastructure token common access card for logon to information networks. • Awarded the enterprise license for the host-based security solutions software, which includes tools to support policies, centralized management of host-based computer network defense capabilities, and the prevention of unauthorized access to files and information. • Completed the formal coordination of the revised security certification and accreditation policy to improve compliance and provide an enterprise management capability. Directed components to appropriately report all security weaknesses identified in their annual reviews. • Developed an on-line knowledge service providing detailed guidelines, standards, and tools for security certification and accreditation. • Completed the draft Version 1.1 of the information assurance component of the Global Information Grid architecture. • Made available the enterprise automated certification and accreditation capability of the enterprise mission assurance support system. Pilots of the enterprise mission assurance support system are ongoing at multiple components. • Reported 87.1 percent of the systems certified and accredited in the Federal Information Security Management Act report. • Issued the Defense assurance certification and accreditation process in a policy memorandum which is pending review and further synchronization with the certification and assurance revitalization process.

Table IV. Section 2 Overall Systemic Weaknesses - Ongoing	
	B. Planned Milestones for FY 2007 and Beyond: • Achieve 100 percent capability to log onto the Department networks using the public key infrastructure token. • Complete updating the database of the Defense civilian personnel system with detailed information and assurance for the military workforce. • Provide the United States Strategic Command a real-time situational awareness of the Department of Defense information assurance posture. • Publish the final version of the information assurance component of the Global Information Grid architecture. • Incorporate changes to the Department of Defense military personnel databases to support the information assurance workforce management program which will accommodate any delays in the Defense integrated military human resource system. • Sponsor the information assurance management tools at a Defense enterprise computing center. • Achieve 100 percent security certification and accreditation for the Department of Defense systems. • Continue the development of the information assurance component of the Global Information Grid architecture and implement the information assurance capabilities. • Continue to identify and track information assurance for both civilian and military personnel. Correction Target Date: 3rd Qtr, FY 2007
Title	3. Valuation of General Personal Property
Description of Issue	The Department of Defense does not currently meet Federal Accounting Standards for the financial reporting of personal property. Documentation for personal property is neither accurate nor reliable. (Newly reported: FY 2006)
Progress to Date	A. Completed Milestones: • Identified the universe of general equipment for the National Geospatial-Intelligence Agency. • Revised and published the Department of Defense Instruction, “Equipment and Administrative Property.” • Completed documents for functional requirements of the Defense property accountability system.
	B. Planned Milestones for FY 2007 and beyond: • Publish the concept of operations. • Establish the Department of Defense property council. • Identify the universe of general equipment for Army, Navy, Marine Corps, and the Defense Logistics Agency. • Determine values for the Defense Logistics Agency general equipment. • Identify the universe of general equipment for Air Force. • Ensure that the National Geospatial-Intelligence Agency determines values for general equipment. • Ensure that Army, Navy, and Marine Corps determine values for general equipment. • Submit the National Geospatial-Intelligence Agency assertion package, asserting that it is ready for audit. • Complete a technical refresh of Defense property accountability system. • Submit the Defense Logistics Agency assertion package, asserting that it is ready for audit. • Submit the Army assertion package. • Determine values for general equipment for Air Force. • Submit the assertion packages for Navy and Marine Corps. • Complete the National Geospatial-Intelligence Agency audit. • Complete the Army audit. • Recertify and accredit the Air Force management system. • Complete the Defense Logistics Agency audit. • Complete the Navy and Marine Corps audit. • Submit the Air Force assertion package. • Complete the Air Force audit. Correction Target Date: 3rd Qtr, FY 2017

Table IV. Section 2 Overall Systemic Weaknesses - Ongoing	
Title	4. Personnel Security Investigations Program
Description of Issue	The Department of Defense hiring is adversely affected because personnel security investigations are backlogged.
Progress to Date	A. Completed Milestones: • The Office of Management and Budget issued a policy on the reciprocal recognition of existing personnel security clearances in an effort to ensure that background investigations or other requirements are only done when actually required. • The Clearance Verification System, operated and maintained by the Office of Personnel Management, went into initial operation. The Clearance Verification System is the central index for investigative and clearance information within the government. Until the final architecture and requirements are determined and implemented, the Department will maintain its linkage between the joint personnel adjudication system and the Office of Personnel Management security investigations index to share investigative and clearance information on Department of Defense personnel. • The President approved the new adjudication guidelines for determining eligibility for access to classified information and other types of protected information. These guidelines were implemented in FY 2006.
	B. Planned Milestones for FY 2007 and beyond: • Implement the electronic questionnaire for investigative processing for submission of national security investigations to the Office of Personnel Management. • Evaluate the Air Force predictive model for military and civilian investigative requirements for application throughout the Department. • Complete 80 percent of all Department of Defense investigations within 90 days with no case over a year old. • Receive completed investigations electronically from the Office of Personnel Management. • Adequately staff adjudication facilities to meet mission needs. • Adjudicate 80 percent of completed investigations within 30 days. • Develop a strategic plan for the Department of Defense personnel security program. • Implement an automated continuing evaluation system. • Update yearly security forms. • Complete 90 percent of all applications for a personnel security clearance. Complete the investigation in 40 days and the adjudication in 20 days. Correction Target Date: 4th Qtr, FY 2007

Table IV. Section 2 Overall Systemic Weaknesses - Ongoing	
Title	5. Real Property Infrastructure
Description of Issue	The Department has not adequately managed the real property infrastructure to halt the deterioration or obsolescence of facilities on military installations.
Progress to Date	A. Completed Milestones: • Refined the use of the reporting metrics for sustainment and recapitalization of used property infrastructure. • Completed the common reporting of facility condition in the annual submission of real property inventory data and an independent study to validate the methodology of the process. • Deployed the facilities recapitalization model to predict the average annual dollar amount required to update and renew the inventory of facilities on a continual, ongoing basis. • Published the Department of Defense Instruction, "Real Property Inventory and Forecasting," which details guidance for performing the requirements for real property inventory. • Implemented new corporate demolition and disposal procedures that will more adequately capture the net effect on the inventory by eliminating excess and obsolete facilities. • Deployed a test version of the facilities operations model that predicts the requirements for facility-related services, utilities, and leasing. • Reported the facilities data in the Defense readiness reporting system to reflect the impact of facilities on mission readiness. • Completed the Department's reporting of inventory for the federal property profile. • Continued the analytical efforts for developing and implementing the means for identifying facility deficits and for projecting new facility requirements. • Integrated military family housing into other metrics.
	B. Planned Milestones for FY 2007: • Capture real property inventory data elements as prescribed by the Federal Real Property Council for use in the submission to the federal real property profile. • Use metrics and systems' tools already in place to evaluate progress toward goals. Correction Target Date: 1st Qtr, FY 2008

Table IV. Section 2 Overall Systemic Weaknesses - Ongoing	
Title	6. Government Card Program Management
Description of Issue	Instances of misuse, abuse, and fraud in respect to purchase and travel card use, and centrally billed accounts have been attributed to inadequate Department of Defense emphasis on proper use of the cards, poorly enforced controls, and lax oversight.
Progress to Date	Purchase Card Program: A. Completed Milestones: • Cancelled unnecessary cards and reduced workloads on billing officials so that they can perform, timely, and complete reviews of all card transactions. • Developed a comprehensive purchase card concept of operations that the components use as a guide to oversee their programs. • Completed initial field tests of centralized data mining capability to detect fraudulent, wasteful, and abusive card transactions. • Implemented new disciplinary guidelines, specifically targeted to card misuse, and aggressively, prosecuted known fraud cases. • Completed all internal administrative and policy recommendations that were developed internally (to include the Department of Defense charge card task force recommendations) to address purchase card misuse. • Developed a Defense-wide provisioning capability that will provide a web-based means for system users to document and update management and system hierarchies. The purchase card program management office will be the first user of this provisioning capability. • Developed the authorization, issuance, and maintenance capability for the purchase card program management office. Capability will provide an interface to initiate and approve requests for issuance, suspension, or cancellation of purchase card accounts and will have interfaces to the card issuing banks, which create and maintain the purchase card accounts. • Solicited for data mining capability.
	B. Planned Milestones for FY 2007: • Complete Spiral 1 development testing of authorization, issuance, and mining capabilities. • Complete operational testing of provisioning capability. • Initial operating capability of authorization, issuance, and maintenance.
Progress to Date	Travel Card Program: A. Completed Milestones: • Implemented a data mining pilot program with the Bank of America and Visa Corporation to flag and review high risk transactions. • Published a standard training guide. • Developed additional guidelines for management of centrally billed accounts. • Continued to implement premium class travel task force recommendations regarding policies for the Department. • Developed a method for identifying and preventing reimbursements for centrally billed travel tickets claimed on an individual's travel voucher. • Collected approximately $3 million through salary offset. • Closed 6,967 accounts upon review of separation and retirement lists. • Formed the Defense Travel Management Office.

Table IV. Section 2 Overall Systemic Weaknesses - Ongoing	
	B. Planned Milestones for FY 2007: • Enhance the Defense travel system by providing visibility of the charges and additional controls. • Complete the travel card program assessment. • Develop a web based tool for tracking the approvals of premium class travel. • Complete component audits concerning unused tickets, improper payments, and premium class travel. • Form governance boards for policy and regulatory changes. • Continue monitoring travel card performance through monthly metric reviews. • Issue guidance to the components for developing plans of action and milestones in expanding the use of individually billed accounts within the Department of Defense for official travel expenses. Correction Target Date: 4th Qtr, FY 2007
Title	7. Valuation of Inventory on Financial Reports
Description of Issue	The valuation of inventory is not always correctly reported.
Progress to Date	A. Completed Milestones: • Updated the Department of Defense Financial Management Regulation, Volume 11B, Chapter 5. • Issued policy for "Accounting for Inventory Held for Repair in Working Capital Funds" memorandum dated August 4, 2003. • Convened an inventory working group, charged with developing a baseline for inventory valuation, establishing methodologies for valuing inventory, and testing the existence and completeness of assertions. • Developed the methodologies for valuing inventory; identified systems that are compliant with and could sustain moving average cost inventory valuations; developed processes to baseline compliant systems and sustain those baselines using moving average cost methodology; and developed timelines and approaches to completing baselines for all systems to include testing existence and completing assertions. • Worked with the Federal Accounting Standards Advisory Board to interpret and apply standards to the Department's processes. • Issued an update to the policy on unique identification of assets memorandum for new equipment, major modifications, and reprocurement of equipment and spares. • Issued an interim Defense federal acquisition regulation supplement on item unique identification memorandum entitled, "Item Unique Identification and Valuation." • Issued the policy on radio frequency identification memorandum entitled, "Radio Frequency Identification Policy Update." • Published the Defense federal acquisition regulation supplement clause governing application of passive radio frequency identification in the federal register for public comments. • Issued the final item unique identification rule published for the Defense federal acquisition regulation supplement. • Included the valuation requirements in the enterprise transition plan. • Included milestones for completion in the financial improvement and audit readiness plan.
	B. Planned Milestones for FY 2007 and beyond: • Update the financial improvement and audit readiness plan. • Publish the Defense federal acquisition regulation supplement clause governing the application of tags to remaining commodities and locations. • Ensure the solicitations and contracts for government furnished property meet the item unique identification requirements. • Publish the in-transit inventory accountability policy. • Extend the item unique identification to legacy items. • Implement systems and processes to sustain baselines. Correction Target Date: 4th Qtr, FY 2016

Table IV. Section 2 Overall Systemic Weaknesses - Ongoing	
Title	8. Improper use of Non-Department of Defense Contracting Vehicles
Description of Issue	Non-Department of Defense contracting vehicles have been used improperly to procure services or supplies.
Progress to Date	A. Completed Milestones: • Commenced workforce training with continuous learning module established on the Defense Acquisition University website and additional roadshow training. • Conducted outreach programs with assisting civilian agencies. • Issued a policy memorandum. • Issued an interim rule to implement requirements of the Ronald W. Reagan National Defense Authorization Act for FY 2005. • Reported on the Department's use of non-Department contracts from assisting civilian agencies. • Completed a compliance review regarding implementing policy regarding the proper use of non-Department contracts. • Issued guidance on the proper use of interagency agreements for non-Department contracts under authority other than the Economy Act. • Established a joint task force.
	B. Planned Milestones for FY 2007: • Issue a policy memorandum on "Severable Services." • Expand the utilization of interagency acquisition website. • Establish a senior level memorandum of agreement with the General Services Administration, the Department of the Interior, and the National Aeronautics and Space Administration. • Establish a senior level memorandum of agreement with the Department of the Treasury, the National Institutes of Health, and the Department of Veterans Affairs. Correction Target Date: 2nd Qtr, FY 2007

Table IV. Section 2 Overall Systemic Weaknesses - Ongoing	
Title	9. Department of Defense Contracting for Services
Description of Issue	The Office of the Inspector General, Department of Defense and the Government Accountability Office, have identified deficiencies in the policy for, and the execution of, procurement for services.
Progress to Date	A. Completed Milestones: • Resolved overpayment issues identified in the Department of Defense Inspector General report. • The Army reviewed all logistic civil augmentation plan contract orders to ensure that contracts are within scope and backlog of undefinitized orders eliminated. Developed new procedures to ensure prompt completion. • Revised the policy on the proper use of other agencies' contracts to include conducting surveillance of services procured from other agencies' contracts. • Published an updated policy on how to appoint and train contracting officer representatives. The Defense Acquisition University updated the contractor officer representatives training. • Established working groups that were identified in the improvement plan. Implemented the improvement plan and initiated periodic status briefs on the improvement plan and systemic weaknesses to senior Defense leadership. • Issued a policy memorandum on the performance based services acquisition and required progress reports on performance based services acquisition training for individuals participating in the preparation of performance based work statements. • Developed metric goals and thresholds for the strategic sourcing program. • Developed a concept of operations for the Department of Defense strategic sourcing. • Updated the plan for improving the Government Accountability Office high risk areas of contract management. • Published guidance regarding procedures for and use of, waivers to competitive requirements. • Reviewed and updated the policy on quality assurance surveillance and written oversight plans. • Published the Acquisition, Technology and Logistics Workforce Human Capital Strategic Plan. • Established goals for FY 2006 and beyond on the competition of task and delivery orders under multiple award contracts. • Published policy entitled "Management Structure for the Procurement of Contract Services," which implements the National Defense Authorization Act for FY 2006 requirements. • Designated senior officials who are required to ensure that their service contract review processes and data collection requirements support adequate contract surveillance. • Reviewed component data for the top 20 acquisitions of services. • Designated that senior officials verify that their service contract review processes and data collection requirements adequately support contract surveillance.
	B. Planned Milestones for FY 2007: • Address the Government Accountability Office high risk areas in training or policy requirements. • Review the guidance procedures for task orders, competition, price reasonableness determinations, and quality assurance surveillance in response to weaknesses identified in the Department's self assessment. • Implement the spend analysis of the initial acquisition. • Process 51 percent of invoices applicable to each military department office through wide area work flow. • Complete component self assessments of pricing techniques, performance based services acquisition, and quality assurance surveillance and written oversight plans. • Complete 80 percent of the training for personnel who develop statements of work. Correction Target Date: 4th Qtr, FY 2007

Table IV. Section 2 Overall Systemic Weaknesses - Ongoing	
Title	10. Federal Procurement Data Reporting
Description of Issue	The new Federal Procurement Data System is not fully functional causing inaccurate procurement reporting data and increased costs required for continued maintenance of legacy systems.
Progress to Date	A. Completed Milestones: • Established a joint Federal Procurement Data System-Next Generation migration team. • Identified outstanding requirements to the General Services Administration, necessary to transition to the new system. • Certified the contract writing systems that directly report to the new system. • Certified that all FY 2005 data has been submitted to the Federal Procurement Data System-Next Generation. • Completed testing to ensure that data from FY 1997– 2004 has been appropriately migrated from the original source system.
	B. Planned Milestones for FY 2007: • Certify that all FY 2006 data has been submitted to the Federal Procurement Data System-Next Generation. • Receive certification from the General Services Administration that the Federal Procurement Data System-Next Generation attained full operating capability. • Initiate decommissioning of component feeder systems. • Complete migration from the current reporting environment to the Federal Procurement Data System-Next Generation. Correction Target Date: 2nd Qtr, FY 2007
Title	11. Department of Defense Accounts Payable
Description of Issue	The Department of Defense does not meet accounting standards for the financial reporting of public accounts payable because of its inability to support balances due to a lack of standard procedures for recording, reporting, and reconciling the amounts between the financial, accounting, and reporting systems.
Progress to Date	A. Completed Milestones: • Establish a plan of action and milestones. • Name accounts payable as a focus area in the financial improvement and audit readiness plan for concerted effort and attention to corrective action milestones. • Develop a monthly report and tool for reconciling accounts payable balances between the financial, accounting, and reporting systems.

Table IV. Section 2 Overall Systemic Weaknesses - Ongoing	
	B. Planned Milestones for FY 2007 and Beyond: • Ensure implementation of the standard guidance provided in the Department of Defense Financial Management Regulation, Volume 4, Chapter 9, Accounts Payable. • Identify and document accounts payable universe. • Establish and implement the processes to initiate and record accounts payable in a timely manner. • Complete the Office of Management and Budget Circular A-123 requirement for the annual assessment on internal controls over financial reporting. • Identify the costs and submit budget requirements for preferred solutions. • Coordinate and obtain the approvals from appropriate offices (Investment Review Boards, Defense Business Systems Management Committee). • Obtain funding for the preferred solution. • Ensure the cleanup of the Department's legacy systems. • Ensure all material audit recommendations were addressed. • Identify and document the preferred solution's key processes, internal controls, and risk assessments. • Populate the accounts payable reconciliation tool with data from major financial systems. • Populate the accounts payable reconciliation tool with data from the remaining financial systems. • Complete implementation of the accounts payable repository at the transaction level for budgetary and proprietary reporting. • Implement the preferred solution for intragovernmental accounts payable. • Submit assertion packages for the components. • Complete all audits. Correction Target Date: 4th Qtr, FY 2015

Table V. Section 4 System Nonconformance Weaknesses - Ongoing	
Title	Department of Defense Financial Management Systems and Processes
Description of Issue	The Department of Defense financial and business management systems and processes are costly to maintain and operate, not fully integrated, and do not provide information that is reliable, timely, and accurate.
Progress to Date	See Table IV, number 1 above, for progress explanation.

Table VI. Section 2 Financial Reporting Weaknesses	
Title	1. Valuation of Military Equipment Assets
Description of Issue	The Department's inability to accurately report the financial value of military equipment supports the probability of material misstatement in financial reporting.
Progress to Date	A. Completed Milestones • Documented the acquisition costs for military equipment acquired for 1,101 military equipment programs. • Implemented a core system capability to value and depreciate military equipment assets. • Reported the updated acquisition and disposal costs on the 3rd Quarter, FY 2006 financial statements. • Developed and delivered training classes for updating baseline valuations.
	B. Planned Milestones for FY 2007 and Beyond: • Use the baseline valuation methodologies for FY 2006 year-end close. • Conduct initial operational testing and loading of data for the first military equipment increment of the Capital Asset Management System to obtain full operational capability. • Achieve initial operating capability for the second increment of the Capital Asset Management System – Military Equipment. • Transfer responsibility for acquisition cost valuation to the Military Services. • Complete audit of baseline values. Correction Target Date: 1st Qtr, FY 2010

Table VI. Section 2 Financial Reporting Weaknesses	
Title	2. Valuation of Real Property Assets
Description of Issue	The Department of Defense does not have adequate internal controls in place to provide assurance that real property assets are identified and properly reported in its financial reports.
Progress to Date	A. Completed Milestones: • Published a revision to the Department of Defense Financial Management Regulation, Volume 4, Chapter 6, "General Property, Plant, and Equipment" that codifies the Statement of Federal Financial Accounting Standards. • Issued a revised capitalization threshold that capitalizes 99 percent of real property assets. • Standardized the core data elements for a real property inventory repository and issued the Department of Defense Instruction 4165.14, "Real Property Inventory and Forecasting." • Received the Military Services' plans for implementing the real property inventory repository requirements to streamline the business processes, standardize data elements, and put into practice the business rules as depicted in the Department of Defense business enterprise architecture. • Conducted a business process reengineering of the construction in progress to identify sustainable business processes and management controls that will improve reliability for construction in progress cost information.
	B. Planned Milestones for FY 2007 and Beyond: • Validate the Military Services' implementation of standardized data reporting for real property assets. • Develop a common Department-wide real property baseline methodology. • Revise guidance on standardized transactions for acceptance and transfer of real property assets. • Inspect cost and purchase documents of selected assets for existence, pricing, and ownership rights. • Check the United States Standard General Ledger posting of asset accounts to ensure correct posting logic and categorization. • Continue to monitor Military Services' progress toward implementing the real property inventory requirements and business processes to ensure consistency with the enterprise transition plan. • Validate that the Military Services have updated and developed new policies and procedures for real property accountability and real property financial reporting. Validate that the Military Services have initiated implementation of sustainable procedures. • Validate that the Military Services have completed implementation of the real property inventory requirements of sustainable business processes, standard data elements, and consistent management controls. Validate that the Military Services have begun monitoring the operational effectiveness of these processes and systems. Correction Target Date: 4th Qtr, FY 2009

Table VI. Section 2 Financial Reporting Weaknesses	
Title	3. Reporting of Environmental Liabilities
Description of Issue	The Department of Defense internal controls for reporting environmental liabilities do not provide assurance that cleanup costs for all of its ongoing, inactive, closed, and disposal operations are identified, consistently estimated, and appropriately reported.
Progress to Date	A. Completed Milestones: • Issued guidance to accomplish an initial inventory of operational ranges inventory and assess the environmental condition of the operational ranges. • Reported the operational range inventory to Congress in February of FY 2004. • Revised the Department of Defense Financial Management Regulation to add procedures for recognizing liabilities and reporting on operational ranges and munitions response areas. • Completed the final inventory of munitions sites (other than operational ranges). • Developed and issued an interim change to the regulation that requires the reconciliation of real property and environmental site records. • Developed and coordinated guidance on how to conduct operational range assessments. • Developed and coordinated guidance on how to report and forecast real property inventory. • Formed an environmental liabilities policy workgroup, with representation from the Department components, to assist in implementing the new environmental liabilities' policy and guidance. The workgroup is improving standardization of business processes across the components. • Published the "Best Practices Guide for Environmental Liabilities" which provides best practices for preparing for an audit and proper accounting that supports environmental liabilities in financial statements. • Issued guidance for recognizing, measuring, and reporting environmental liabilities not eligible for the defense environmental restoration program funding (i.e., non-defense environmental restoration program guidance), November 15, 2005. This guidance allows the components to develop procedures for identifying and estimating future liabilities not previously addressed under current programs. • The Department of Navy completed a "fence-to-fence" survey of all Navy installations and estimated the environmental disposal liabilities for all conventional and nuclear ships and submarines. • Through the environmental liabilities workgroup, the components provided input to an updated and standardized key milestone plan within the financial improvement and audit readiness plan to help identify a critical path to achieve a clean audit. • Updated the guidelines for Note 14, Environmental and Disposal Liabilities, of the consolidated financial statements to meet the new disclosure requirements and improve Department-wide reporting. • The Department of the Navy completed a "fence-to-fence" survey and developed preliminary cost estimates of the environmental liabilities for the non-defense environmental restoration program at all the Department of Navy installations.
	B. Planned Milestones for FY 2007 and Beyond: • Identify the universe of environmental liabilities' candidate units, facilities, and property where environmental issues have been identified. • Document that all property plant and equipment records have been reviewed and properly recorded for environmental liabilities. • Complete and document initial estimates for all sites in the environmental liabilities universe. • Develop policies and procedures to identify, calculate, and record closing and disposal costs for environmental liabilities. • Develop and implement internal controls for identifying, calculating, and recording closing and disposal costs for environmental liabilities. Correction Target Date: 2nd Qtr, FY 2009

Table VI. Section 2 Financial Reporting Weaknesses	
Title	4. Reporting of Defense Health Care Liabilities
Description of Issue	The military health care current financial processes cannot collect accurate cost and performance information to produce reliable Department of Defense health care financial reports and actuarial liabilities.
Progress to Date	A. Completed Milestones: • Established procedures requiring the Military Service medical facilities to submit monthly reports on the quality of their medical records. • Published a Department-wide policy on how to code medical records. • Developed a reconciliation process for reviewing expense data at Military Service medical facilities.
	B. Planned Milestones for FY 2007 and Beyond: • Construct records that contain data that tracks supplementary patient services and matches to the patient's initial contact with the provider. • Fully install a coding compliance editor system within all the military treatment facilities. • Develop a process for the distribution of funds using the "prospective payment method." • Incorporate the use of Medicare rates into the Medicare-Eligible Retiree Health Care Fund distribution plan for patient encounters and incorporate the use of Medicare rates for estimating actuarial liability. • Implement systems that will reconcile source data used in actuarial estimates with financial records. • Purchase and install a commercial off-the-shelf pharmacy system to interface with the health care accounting system. Correction Target Date: 2nd Qtr, FY 2009

Table VI. Section 2 Financial Reporting Weaknesses	
Title	5. Fund Balance with Treasury
Description of Issue	The Department of Defense is unable to reconcile cash account balances to the Department of the Treasury cash account balances.
Progress to Date	A. Completed Milestones: • Documented transaction processes such as reconciling, tracking, and reporting clearing accounts. Also documented payments of intra-governmental accounts. • Developed reports to identify the amount of adjustments prepared each quarter. • Ensured the cash reconciliation system was used as a reconciliation tool for funds. • Determined the proper solution for resolving a $238 million negative cash balance. • Established operating procedures to ensure timely updates of edit tables. • Developed clear definitions for a balanced scorecard measure and monthly in-transit disbursements report to ensure consistency among the reports. • Implemented full operational capability of the cash reconciliation system. • Documented the entire reconciliation process for the Treasury Index 97 general fund, including specific procedures of the various reconciliations within the overall process. • Modified interfund business procedures to eliminate the use of incorrect "default" subheads on transactions. • Completed research, reconciliation, and resolution of the Treasury Index 97 general fund departmental adjustments. • Developed a procedure to reduce the number of days required to post entries to the accounts.
	B. Planned Milestones for 2007 and Beyond: • Identify and document processes and controls that significantly impact the Fund Balance with Treasury balances. • Perform risk control assessments to identify potential weakness areas. • Develop corrective action plans to mitigate identified weaknesses. • Test critical systems and implement compensating controls to mitigate deficiencies and produce accurate Fund Balance with Treasury transactions. Correction Target Date: 3rd Qtr, FY 2008

Note: In some instances, there may be date inconsistencies between the PAR and Component source information. The Department will review this matter and make appropriate adjustments as needed during FY 2007.

Auditor-Identified Financial Statement Weaknesses

Audits performed by the Department Inspector General identified several financial statement material weaknesses. A material weakness is a technical term referring to an identified problem that may impact the accuracy and reliability of financial information. The majority of the auditor-identified weaknesses and corrective actions are reported as material internal control weaknesses by the Department in this section. The auditor-identified material weaknesses not individually included in the Department's inventory of material weaknesses are Intragovernmental Eliminations, Accounting Entries, Government Property and Material in the Possession of Contractors, and Operating Materials and Supplies. Resolving these material weaknesses requires the initiatives, system solutions, and corrective actions developed and outlined in the Department's Financial Improvement and Audit Readiness Plan and the Department's Enterprise Transition Plan discussed in Section 1: Management's Discussion and Analysis.

Inspector General's Summary of Management and Performance Challenges

Based on audits, investigations, and inspections, the Inspector General (IG) identified six management and performance challenges for FY 2006 compared to the nine challenges reported for FY 2005. In identifying the six challenges the Office of the Inspector General (OIG) has combined elements of previously identified management challenges and added new challenges. Information technology management is now part of the larger issue of "Information Security and Privacy," logistics and homeland defense are now part of "Joint Warfighting and Readiness," and "Acquisition Processes and Contract Management" now include information technology acquisition. Additionally, with Base Realignment and Closure (BRAC) decisions made, the challenge of Infrastructure and Environment was removed. However, implementation of those decisions will affect Department employees, so BRAC issues pertaining to personnel were merged with Human Capital. The challenge areas, summarized in the following pages, include:

- Acquisition Processes and Contract Management
- Financial Management
- Health Care
- Human Capital
- Information Security and Privacy
- Joint Warfighting and Readiness

Acquisition Processes and Contract Management

The Department's management challenge is to provide required materiel and services that are superior in performance, high in quality, sufficient in quantity, and reasonable in cost despite the ever increasing volume and complexity of purchases. Every acquisition dollar that is not prudently spent results in the unavailability of that dollar to fund the top priorities of the Secretary of Defense and wastes valuable taxpayer dollars.

Ensuring the appropriate size and experience level of the acquisition workforce in light of changing acquisition strategies and vehicles, prior downsizing, and an aging workforce, is a challenge.

Management is also challenged to make appropriate use of acquisition streamlining initiatives. Government quality assurance is more limited under commercial contracts. Before procuring against a commercial specification, the procurement community must be vigilant in deciding that the item will meet warfighter requirements as well as being a truly commercial item. The Department also continues to experience a variety of shortcomings in its approach to compliance with the DoD 5000 series of guidance and the Federal Acquisition Regulation in FY 2006. The OIG identified instances where Army acquisition officials misused appropriated funds by not complying with the DoD

5000 series of guidance and the Federal Acquisition Regulation.

The Department also has significant challenges regarding purchases made through other agencies for the Department. Last year, the OIG found that Military Interdepartmental Purchase Requests used primarily in the fourth quarter of FY 2004 did not comply with the appropriations law and the Federal Acquisition Regulation for making purchases through other agencies. These purchases were valued at approximately $406 million.

The Department has a goal to influence development of acquisition, planning, and innovation processes that will further the information assurance mission and support transformation of the force. One of the strategic objectives of the goal is to ensure that information assurance is integrated and sustained throughout the life cycle of Department programs. The objective states that Department business processes should include information assurance across the enterprise and conform to the Administration's "smart buy" concept. The Department is challenged to ensure that contracting for Information Technology (IT) includes information assurance and all contracting clauses required by the federal and Department regulations to safeguard our IT infrastructure.

Inspector General Assessment of Progress

The Department has made progress improving numerous acquisition processes. Despite progress, the increasing volume of acquisitions, the decrease in the number of acquisition personnel, and the numerous types of contracting vehicles and methods for accomplishing acquisition make this a long-term challenge. The Department management reacts positively after problems are identified; however, the sheer volume of contracting and the pressures on contracting officials to award procurements faster make the challenge of correcting the problems more difficult.

The Department needs to continue to vigilantly investigate allegations of corrupt acquisition, both criminally and administratively. Unfortunately, the works of a few to undermine the integrity of the acquisition process can set back the success of millions of acquisition actions within the Department. The Department also needs to strike a proper balance between reducing the time to award procurements and maintaining adequate controls to safeguard scarce resources. Use of acquisition streamlining initiatives such as buying commercial items makes sense, but buying unique major military systems as commercial items does not.

Financial Management

The Department faces financial management challenges that are complex, long-standing, and pervade virtually all of its business operations, thus affecting the ability to provide reliable, timely, and useful financial and managerial data to support operating, budgeting, and policy decisions. The Department's financial management problems are so significant that they constitute the single largest and most challenging impediment to the U.S. Government's ability to obtain an opinion on its consolidated financial statements. The weaknesses that affect the auditability of the financial statements also impact other Department programs and operations and contribute to waste, mismanagement, and inefficient use of Department resources.

The Government Accountability Office first identified Department financial management as a high-risk area in 1995, a designation that continues to date. Combined with the high-risk areas of business systems modernization (designated a high-risk area in 1995), and supply chain management (designated a high-risk area in 1990), these three areas directly affect the Department's ability to attain an unqualified audit opinion on its financial statements. In its March 3, 2006, Executive Branch Management Scorecard, OMB assessed the status of the

Department's financial performance as "Red," or "Unsatisfactory."

The Department OIG previously identified and reported on several material control weaknesses that reflect some of the pervasive and long-standing financial management issues faced by the Department and prevent the Department from obtaining an unqualified opinion on its financial statements. These weaknesses also affect the safeguarding of assets and proper use of funds, thus impairing the prevention and identification of fraud, waste, and abuse, to include the following:

- Fund balance with Treasury
- Inventory
- Operating materials and supplies
- Property, plant, and equipment
- Government-furnished material and contractor-acquired material
- Environmental liabilities
- Financial management systems
- Intragovernmental eliminations
- Other accounting entries
- Statement of Net Cost
- Statement of Financing

The following elements and actions are essential to improving the Department's financial management:

- Create an environment that fully supports clean financial reporting. The financial managers need buy-in from senior management and personnel in the field offices in order to successfully implement the corrective action plans.
- Maintain a significant level of continued review to identify all of the material financial management and reporting deficiencies, internal control weaknesses, and quality of data issues.
- Develop corrective action plans that will adequately correct the deficiencies and result in financial reporting in accordance with generally accepted accounting principles.
- Implement the corrective action plans that address the system, control, reporting, or quality of data weakness.

Inspector General Assessment of Progress

One significant measure of the ongoing progress in the area of financial management would be the Department's ability to obtain unqualified audit opinions on its financial statements. The Department is far from reaching this milestone as demonstrated by the audit opinions received by the Department and its components on their FY 2005 and 2006 financial statements.

However, the Department's ongoing initiatives in the area of financial management improvement indicate that the Department management is responding to the significant and pervasive financial management issues and is positioning itself to leverage planned systems and business improvements to achieve sustainable and long-term solutions. The Department has made progress by establishing a framework to direct and hold managers accountable for the Department's financial improvement efforts. The framework, called the Financial Improvement and Audit Readiness (FIAR) improvement initiative, comprises a directorate that is responsible for centrally coordinating the initiative; a regularly updated, written plan with stated objectives and milestones; a defined process with protocols for making decisions; a tool for tracking progress; and oversight groups consisting of participants from across the Department to guide the decision making process.

The FIAR plan categorizes the financial management challenges faced by the Department into three broad categories: those that heavily depend on systems solutions; those that depend primarily on process solutions; and those that depend on both systems and process solutions. The FIAR plan focuses on the process solutions that Department financial managers identify, develop, and implement to correct financial reporting deficiencies or internal control weaknesses.

The Department OIG has primarily focused its audit efforts on the FIAR improvement initiative. The Enterprise Transition Plan addresses systems solutions. The Department has made progress by establishing the Business Transformation Agency and developing the business enterprise architecture and the Enterprise Transition Plan.

The Department OIG considers the following Department financial management efforts to be successes:

- implementation of integrated organizational structures and processes to address financial management improvement,
- assignment of accountability to Department managers,
- Department improvement initiatives at the entity and line item level, and
- self-assessment of controls over financial reporting related to OMB Circular A-123, Management's Responsibility for Internal Control.

Although the Department OIG anticipates that Department will need to make refinements in these areas, the Department OIG considers these to be critical steps in establishing a culture and ingrained structure that will (1) enable Department managers to identify internal control weaknesses, (2) effectively plan for resolution of those weaknesses, and (3) hold Department managers accountable for improving internal controls over financial reporting. Further, these steps should result in a financial management structure that can provide accurate, relevant, and timely financial management information for decision making.

We fully support the Department's goal to implement internal controls that will result in sustained improvements in its ability to produce timely, reliable, and complete financial management information. To that end, the Department needs to continue to develop comprehensive, integrated plans that will lead to improved systems and internal control. We recognize that there are many variables affecting the execution of the Department improvement initiatives, such as the ability of specific Components' to make corrective actions and meet the projected milestones. The Department OIG will continue to provide input to the Department managers on these initiatives as requested, or as part of the Department OIG advisory role on the Department committees that support these initiatives.

Health Care

The Department Military Health System must provide quality care for approximately 9.2 million eligible beneficiaries within fiscal constraints while facing growth pressures, legislative, imperatives and inflation that make cost control difficult in both the public and private sectors. The Department challenge is magnified because the Military Health System's primary mission is to provide health support for the full range of military operations. Part of the challenge in delivering health care is combating fraud. As of June 30, 2006, health care fraud constituted 8 percent of the 1,595 Defense Criminal Investigative Service's open cases.

A major challenge to the Department is sufficient oversight of the growing cost of health care for military members. The increased frequency and duration of military deployment further stresses the Military Health System in both the Active and Reserve components. The Department's budget for health care costs was $38.4 billion in 2006, including $20.4 billion in the Defense Health Program appropriation, $6.9 billion in the Military Departments' military personnel appropriations, $0.3 billion for military construction, and $10.8 billion for contributions to the Department's Medicare-Eligible Retiree Health Care Fund to cover future costs of health care for Medicare-Eligible retirees, retiree family members, and survivors. The Department's challenge is how to oversee the growing cost of health care for military members.

A challenge related to medical readiness remains the completion of a Medical Readiness Review (MRR)

being overseen by a steering group co-chaired by the Under Secretary of Defense for Personnel and Readiness and the Director, Program Analysis and Evaluation. The MRR continues to identify medical readiness and personnel management capabilities required by the National Security Strategy and related transformation of war fighting. Readiness of the medical staff and units includes ensuring that medical staff can perform at all echelons of operation and that units have the right mix of skills, equipment sets, logistics support, and evacuation and support capabilities. As with most Department functions, the Military Health System continues to face the challenges of increased joint operations.

The FY 2004 National Defense Authorization Act authorized temporary provisions to expand TRICARE health and dental coverage for Reserve Component members and families. The FY 2005 National Defense Authorization Act permanently extended the benefits for Reserve Component members and their family members. The challenge of keeping reservists medically ready to deploy continues because of the frequency and duration of Reserve deployments.

Inspector General Assessment of Progress

The Department's Military Health System has been moving forward on improving health care while attempting to control costs. It has made significant progress in implementing new TRICARE contracts. TRICARE transitioned from 12 regions and 7 contracts in the United States to 3 regions and 3 contracts. The contracts provide incentives for customer satisfaction and include the managed care support contractors as partners in support of medical readiness. Some issues still exist as the Military Health System enters its third year with the new contracts. Lessons learned are being developed that will be used to improve the next set of contracts.

The Department continues to pursue the implementation of federal ceiling prices for pharmaceuticals. The issue is in litigation with industry because some companies in the industry have challenged the government's legal right to control prices by establishing ceilings. Resolution of this issue could allow the Military Health System to realize millions of dollars of savings annually in pharmacy costs dispensed in the retail venue. Also, in an attempt to sustain medical benefits and costs, the Military Health System proposed modifications to beneficiary costs. The status of the proposal is in question and currently being reviewed in Congress.

The Medical Readiness Review continues. Four working groups are addressing: medical readiness capabilities, casualty estimation, capability metrics, and medical resources. The review has completed significant portions of its review of military resource requirements. Because of the dynamics of troop deployments and other factors, the review continues to operate as conditions warrant. A tentative completion date is December 2006. The focus of the Medical Readiness Review was expanded to address operational tempo issues, the Military Health System role in the Global War on Terror, and national disaster response.

Although the challenge of medically preparing reservists and guardsmen for deployment still exists, the Military Health System has tools available to commanders to screen deployers both pre-deployment and post-deployment, and to assist the deployed reservists' and guardsmen's family members. The Department also has a deployment-based medical service contract (FEDS-HEAL) to assist units with screening, dental services, immunizations, needed medical appointments, and administrative support.

Human Capital

The challenge in the area of human capital is multifaceted. The Department must ensure that its Total Force, which includes Active Component, Reserve Component, civilians, and contractors, is:

- Appropriately sized,
- Maintaining a balanced level of skills to support core defense capabilities,
- Motivated,
- Held to high standards of integrity,
- Capable of functioning in an integrated work environment, and
- Capable of handling the emerging technologies and threats.

The Department's challenge in human capital includes implementing the National Security Personnel System (NSPS) and minimizing disruption from Base Realignment and Closure (BRAC).

The Department's challenges also involve issues such as the continuing and growing backlog of security clearances and correcting past deficiencies in the Defense Security Service handling and processing of security clearances. The security clearance backlog directly affects the placement of both Department and contractor personnel in needed positions.

The Department also faces a challenge in meeting its goal to reduce preventable accidents. Accidents not only reduce readiness through lost man-hours and the unavailability of personnel but are estimated to cost the Department approximately $25 billion a year. In May 2003, the Secretary of Defense challenged senior leaders within the Department to reduce in 2 years the accident mishap rate by 50 percent. In March 2004, the Secretary challenged Department managers to reduce accidents 75 percent by 2008. The challenge for the Department is to make safety an institutional value. Responsibility for environment, safety, and health policy is dispersed throughout the Department.

Inspector General Assessment of Progress

The Department issued a new Personnel and Readiness Strategic Plan in April 2006 that focuses on developing the right mix of people and skills across the Total Force. The plan is a critical piece in the Department's efforts to meet their personnel and readiness goals.

The Department is phasing in the NSPS, the system designed to change how the Department hires, pays, promotes, disciplines, and fires its civilian workforce to make practices more in line with personnel practices in the private sector. The Department has conducted meetings with employees, unions, and other affected parties and has formed working groups to identify and develop options and alternatives for NSPS. The Department has adjusted its implementation schedule to better effect the changes needed for the program. It has developed communications to target groups within the Department and methodologies to gauge effectiveness.

The Department has required business plans to implement the Base Realignment and Closure (BRAC) recommendations, but the extent of the loss of human capital skills is pending on the progress and effectiveness of the implementation. Employees may leave or retire instead of moving to a new location or face the uncertainty of being downsized. Many of the BRAC recommendations will be implemented in years 2008 through 2011 which further increases the level of uncertainty. It is too early in the implementation phase to determine the extent of loss of specialized and general skills and whether the Department adequately planned for this loss.

The Department has taken some steps to address identified problems within the personnel security clearance program. However, longstanding issues must be resolved to make any meaningful progress in reducing the backlog and ensuring a more effective and efficient end-to-end security clearance process. Resolution of these systemic problems should contribute to a more fiscally sound program.

Reducing preventable accidents remains a challenge for the Department. The Department did not achieve the Secretary's goal of reducing accidents by 50 percent. The Defense Safety Oversight Council was

established to facilitate oversight of the Department's efforts to achieve the Secretary's goal. The council is working to determine which indicators should be tracked and how to collect such data and is exploring leading (pre-accident) rather than lagging (post-accident) indicators. The Under Secretary of Defense for Personnel and Readiness has issued guidance that includes using safety management and results in performance plans and appraisals.

Information Security and Privacy

Ensuring that a robust information security program is in place is still a challenge to the Department. Such a program includes periodic risk assessments; security awareness training; security policies, procedures, and practices, as well as tests of their effectiveness; and procedures for addressing deficiencies and for detecting, reporting, and responding to security incidents.

The Department has developed five priorities for information assurance: protecting information, defending systems and networks, providing situational awareness, improving information assurance capabilities, and creating a professional information assurance workforce. However, there is no action plan to assess the effectiveness of these initiatives.

The Department also faces the challenge of ensuring that privacy protections are not compromised by advances in technology.

One of the major challenges identified last year was implementation of the Health Insurance Portability and Accountability Act. Challenges continue for protecting sensitive personal and medical information as the Department and health care industry move toward electronic health care records.

Inspector General Assessment of Progress

The Department has made little progress during the course of FY 2006 in improving its information security posture. Unresolved issues are now exacerbated by the recent losses of privacy data by various federal agencies, including components of the Department, and the dearth of clear Department policy from the Assistant Secretary of Defense (Networks & Information Integration) regarding protection of privacy data.

The Department also has made little progress during the course of FY 2006 in improving its information assurance posture and has not addressed key policy issues pertaining to that posture. Although the Deputy Secretary of Defense assured the Director of the Office of Management and Budget on November 8, 2005, that the Department would resolve such issues as the applicability of National Institute of Standards and Technology standards and guidelines to the Department, the lack of a standard definition of "system" for reporting purposes, and the lack of an adequate Department inventory of information systems, little or no progress has been made.

The Department continues to make progress implementing the Health Insurance Portability and Accountability Act. Ongoing efforts throughout the federal government to better use encryption capabilities will assist in lessening this challenge. The Administrative Simplification Enforcement final rule, effective March 2006, covers civil penalties for violations of administrative simplification provisions of the Act.

Joint Warfighting and Readiness

The challenge in the area of Joint Warfighting and Readiness is to provide the right force, the right personnel, the right equipment, and supplies in the right place, at the right time, and in the right quantity, across the full range of military operations. To meet this challenge, the Department is continuously transforming.

While U.S. forces continue to operate around the world, changes are underway to better align the

resources of the Department to benefit the warfighters, wherever they are located. Those changes have taken a variety of forms, not the least of which is the improvement of the tools used to fight the enemies of the United States. The fight against terrorism, as well as the ongoing Operations Enduring Freedom and Iraqi Freedom, continue to test the limits of the Department and its ability to successfully defend the United States. But those have been shared battles, with each Service shouldering its portion of the load.

The Global War on Terror will continue to be a long and difficult war affecting the entire global community. It will require firm commitment and cooperation of U.S. allies and coalition partners, as well as international organizations, domestic state governments, and the private sector. The demands placed on the U.S. forces the past few years have been extensive, but our military is unwavering in its focus, resolve, and dedication to peace and freedom. With Congress's continued strong support, the military will continue to effectively combat terrorism, counter the proliferation of weapons of mass destruction, help Iraq and Afghanistan build a stable and secure future, improve joint warfighting capabilities, and transform the Force to meet future threats.

The Department's available resources are finite and require constant monitoring of our abilities and of the world situation to enable the Department to successfully operate on a global scale. The continued operations in Afghanistan and Iraq require a significant commitment of forces. Meanwhile, the advances by the Peoples Republic of China in modernizing its armed forces and the possibility of nuclear weapons in North Korea and Iran also require constant monitoring. The combination of these various factors continues to challenge the Department.

Transformation of logistics capabilities poses a significant challenge to the Department. The Department's transformed logistics capabilities must support future joint forces that are fully integrated, expeditionary, networked, decentralized, adaptable, capable of decision superiority, and increasingly lethal. In addition, transformed logistics capabilities must support future joint force operations that are continuous and distributed across the full range of military operations.

Supply chain management is a challenge for the Department. The Government Accountability Office (GAO) identified supply chain management as a High-Risk Area because of weaknesses uncovered in key aspects, such as distribution, inventory management, and asset visibility. The GAO has reported on numerous problems associated with supply chain management, such as shortages of items caused by inaccurate or inadequately funded war reserve requirements and the Department's lack of visibility and control over the supplies and spare parts it owns.

Inspector General Assessment of Progress

The Department continues to make progress in the area of Joint Warfighting and Readiness. However, there is still much to do. The drawdown and reorganization of forces in the European and Pacific theaters will add to the ability of the armed forces to readily respond to situations as required. Although the Department is taking positive actions to increase its warfighting ability and readiness posture, opportunities for improvement will continue to exist.

The Department has made progress toward meeting its goal of transforming logistics through numerous initiatives. The Department and the military services have issued policy and procedures to implement performance-based logistics. However, that progress is tempered by the sheer magnitude of logistics operations that will continue to make it a long-term challenge.

The Department has taken actions to improve the supply chain management, such as assigning new organizational responsibilities for distribution, developing a logistics transformation strategy, and implementing other specific process improvements.

However, the Department must be vigilant in ensuring that the strategy for logistics transformation is continuously reevaluated and that new initiatives and systems are adequately funded and effectively implemented.

Government Accountability Office High-Risk Areas

Since 1990, the Government Accountability Office has periodically reported on government operations that it has designated as high risk. Its audits and evaluations identify federal programs and operations that, in some cases, are high risk due to their greater vulnerabilities to fraud, waste, abuse, and mismanagement. In its latest report, the Government Accountability Office designated 26 high-risk areas. Eight involved Department of Defense programs and operations; five involved the Department as well as other federal agencies. The Department-related high-risk areas are listed below.

Department of Defense:

- Approach to Business Transformation
- Business Systems Modernization
- Personnel Security Clearance Program
- Support Infrastructure Management
- Financial Management
- Supply Chain Management (formerly Inventory Management)
- Weapon Systems Acquisition
- Contract Management

Department of Defense and Other Federal Agencies:

- Strategic Human Capital Management
- Managing Federal Real Property
- Protecting the Federal Government's Information Systems and the Nation's Critical Infrastructures
- Establishing Appropriate and Effective Information-Sharing Mechanisms to Improve Homeland Security
- Management of Interagency Contracting

Management's Response to Auditor Challenges

In general, the Department concurs with the concerns identified by the Inspector General in his Summary of Management and Performance Challenges and the issues presented in the Government Accountability Office's High Risk List. The Department is taking progressive steps to evaluate weaknesses across the Department in systems, processes and internal controls. The Department established comprehensive plans, presented throughout this report, that describe the steps necessary to improve these areas of concern within the Department. Without question, the path forward to implement solutions will be challenging, expensive, and require much time. However, the Department has made a good start and has made substantial progress in many areas. The support of the Congress and the Department's many stakeholders, as well as the efforts of individuals and organizations across the entire Department, have contributed to the development of these plans and the progress made in implementing solutions.

Improper Payments Information Act Reporting Details

As discussed in Section 1: Management's Discussion and Analysis, the Department conducted a review of the improper payments per the Office of Management and Budget guidance.

Risk Assessment

The Department reviewed all of its programs and activities and determined that six programs/activities were susceptible to improper payments: Military Retirement, Travel Pay, Military Health Benefits, Military Pay, Civilian Pay, and Commercial Pay. These programs represent approximately 86 percent of the Department's total payments. The Department of Defense performed risk assessments for each of these programs/activities that addressed the strength

of the internal controls in place to prevent improper payments (such as prepayment reviews), system weaknesses identified internally or by outside audit activities, voluntary returns of overpayments by vendors, etc. The subsequent paragraphs summarize the process and results of these assessment surveys. There are two other types of payment programs/activities that the Department did not conduct surveys for and as a result are not discussed below, intragovernmental payments (approximately $75 billion in fiscal year (FY) 2005) and payments for afloat and deployed forces (approximately $600 thousand in FY 2005). The Department is developing a program to cover these remaining program/activity payments.

Statistical Sampling

Military Retirement. During FY 2006, the Department continued the process, implemented in FY 2004, of monthly random reviews of confirmed deceased retiree accounts, in addition to monthly random reviews from the overall population of retired and annuitant pay accounts. Both of these sampling plans are designed to produce annual estimates of improper payments, with probability of 95 percent and sample precision of plus or minus 2.5 percent.

A monthly sample of accounts is selected from the population of confirmed deceased accounts. Each account is audited to determine if the member was overpaid after the member's death. Statistics collected from the review include the number of accounts reviewed, number with overpayments, dollar amount of the overpayment, amount of correct pay (what the payment should have been), and the dollar amount collected back from the member's account/estate within the first 60 days after notification. These sample statistics are projected to the population of deceased retirees to then determine an improper payment rate population estimate for deceased accounts.

Population estimates from the deceased account reviews are then added to any improper payments identified through other than retired pay random or special audits, to determine an overall improper payments population estimate for retired pay.

Travel Pay. The Department performs monthly random post-payment reviews of travel records settled through the Defense Travel System and Integrated Automated Travel System. These reviews satisfy requirements of Certifying Officers Legislation and ensure payments are legal, accurate, and have supporting documentation. These random reviews are designed to produce annual estimates of improper payments, with probability of 95 percent and sample precision of plus or minus 2.5 percent, at the Military Service component level (Army, Navy, Air Force, and Marine Corps).

For travel payments made by the U. S. Army Corps of Engineers, all temporary duty and permanent change of station travel vouchers greater than or equal to $2,500 are subject to a post audit review. A sample composed of every 366th temporary duty travel voucher less than $2,500 is also reviewed. These reviews are designed to produce annual estimates of improper payments, with probability of 95 percent and sample precision plus or minus 2 percent.

Military Health Benefits. To determine the statistically valid estimate of the annual amount of improper payments, the Department uses the following sampling methodology to pull TRICARE (i.e., triple option health benefit plan available for military families) encounter data records for the annual target health care cost audits of the managed care support services contracts.

For each contract option period, a statistically valid sample of claims with care end dates within the specified option period is selected for payment error auditing. Variable sampling, using stratified sampling with optimum allocation, is used to calculate the sample size for the payment errors. The sample size is designed to produce annual estimates of improper payments, with probability of 90 percent and sample precision plus or minus 1 percent.

Claims with a cost less than $100 are not sampled (except for Medicare dual eligibility claims). One sample category includes all claims $100,000 and more. Claims with a cost of greater than $100 but less than $100,000 are broken down into 12 sample categories. A formula is applied to calculate the sample size for each sample category. If the sample category universe count is less than 30, all the claims in that category are audited. The percentage of overpayments for the sample is applied to all the payments to determine the improper payment amounts.

Military Pay. The Department uses a stratified sampling plan designed to produce annual estimates of improper payments at the Military Service component level (annual target sample of 1,800 or 150 accounts monthly per component). The annual sample provides improper payment estimates with 95 percent probability and sampling precision of plus or minus 2.5 percent, at the Service Component level (Army, Navy, Air Force, and Marine Corps).

The Department reviews monthly randomly selected military pay accounts and their associated entitlements and deductions for accuracy. The root cause and detail of the improper payments are documented for correction and follow-up actions. The sample rate is multiplied by the total net pay of the population to determine an estimated improper payment dollar value. Any improper payments identified through means other than the random review are summarized and added to the population estimate (from the random review) to determine an overall population improper payment estimate for military pay.

The FY 2006 improper payments rate for military pay was substantially lower than the FY 2005 rate. Because this large difference is primarily attributed to fewer sampled accounts having high dollar rate erroneous payments, the Department is performing a comprehensive analysis, comparing the types and dollar values of errors from FY 2005 to FY 2006.

Civilian Pay. The Department uses a stratified sampling plan for civilian pay, similar to that used for military pay. The sampling plan is designed to produce annual estimates of improper payments at the Service component level (annual target sample of 1,800 or 150 accounts monthly per component). The annual sample provides improper payment estimates with 95 percent probability and sampling precision of plus or minus 2.5 percent, at the Service Component level (Army, Navy, Air Force, Marine Corps, and Defense Agencies).

The Department reviews monthly randomly selected civilian pay accounts for accuracy. The root cause and detail of the improper payments are documented for correction and follow-up actions. The sample rate is multiplied by the total net pay of the population to determine an estimated improper payment dollar value. Any improper payments identified through means other than the random review are summarized and added to the population estimate (from the random review) to determine an overall population improper payment estimate for civilian pay.

Commercial Pay. The Department uses a stratified sampling plan designed to produce estimates of improper payments at the program (entitlement system) level. These sample results are compared with the Department's database used to track and resolve commercial pay improper payments to develop annual improper payment estimates with 95 percent probability and sampling precision of plus or minus 2.5 percent.

For commercial pay payments made by the U. S. Army Corps of Engineers, a random sample is selected from all commercial payments. The sample size is based on the estimated minimum (374,400) commercial payments expected to be processed in a year. This sample provides annual improper payment estimates with 95 percent probability and sampling precision of plus or minus 2 percent.

Corrective Action Plans

Military Retirement. The improper payments rate for the military retirement is projected to remain nearly the same from FY 2005 ($49.3 million or .1381 percent) to FY 2006 ($48.8 million or .137 percent). The majority of the improper payments are made to deceased retirees (approximately $48.5 million). Random reviews from FY 2006 indicate 95 percent of the overpaid dollars to deceased retirees is recovered within the first 60 days after notification. To reduce the initial improper payment primarily caused by the delay in death notification to the paying office by family members, the Department has substantially improved its internal processing methods and is using data mining techniques with the Social Security Administration. This process allows the Department to receive death notice information through an automated system and helps prevent improper payments by the pay system.

Travel Pay. The Defense Travel System contains numerous automated prepayment flags to alert travelers and approving officials of potential inconsistencies that could result in an improper payment. In addition, results of monthly random reviews of Defense Travel System trip records are summarized and presented to applicable Service component representatives and to Defense Travel System management personnel. These reports include number, dollar value, and reasons for errors discovered among the sampled claims, as well as recommendations to prevent similar errors on future travel records. Analysis indicates most errors are attributed to traveler input or authorizing official oversight. Training of both travelers and authorizing officials is one of the primary tools the Department uses to alleviate these types of discrepancies.

In FY 2006, over 783,000 trip records, with total settlement dollar value of $823.6 million, were processed through the Defense Travel System. As of September 30, 2006, the Department randomly selected and reviewed 30,100 settled trip records with a value exceeding $32.6 million. Improper payments accounted for .968 percent of the tested sample, so projected improper payments in the population of settlements could approach $7.97 million.

Military Health Benefits. The Department has had contracts with payment performance standards for military health benefit claims processing in place for many years. Under the existing managed care support contracts, the Department has a zero tolerance for unallowable costs. If the contractor pays a claim that is not allowable, the Department will not reimburse the contractor. In addition to placing the contractors at risk for unallowable costs, this contractual design provides a built-in incentive for contractors to continually perfect their claims processing system, up to the point where financial costs outweigh the benefits.

The Department currently audits statistically valid samples that over the years have consistently produced an error rate of less than the 2 percent standard contained in the TRICARE contracts. Improperly submitted claims by the provider community, as well as a minimal degree of human error that can be expected with handling a large volume of claims within the tight time parameters established through the prompt payment regulations, cause errors in health care claims processing. Based on the FY 2006 survey, the FY 2006 improper payments rate for the military health benefits is projected to be $140.0 million or 2.0 percent.

Numerous prepayment and post-payment controls are built into the military health benefits' claims processing system to minimize improper payments. Every TRICARE claim is adjudicated against this system of checks and balances. The managed care support contractors are required to utilize specialized software containing specific auditing logic designed to ensure appropriate coding on professional service claims and eliminate overpayments. The software does not set coverage/benefit policy; it merely audits claims for appropriate code combinations. For calendar

year 2005, the prepayment automated software used by managed care contractors accounted for approximately $184 million in cost avoidance for the TRICARE program. The $89 million increase over the calendar year 2004 savings of $95 million can be attributed to the implementation of additional edits, as well as increased claims volume.

Another control is the prepayment review required under the TRICARE contracts. The contractors use this strategy to prevent payment for questionable billing practices. Prepayment review allows for a closer examination of the services rendered and may require the provider to submit medical documentation to support the services billed. In calendar year 2005, prepayment review resulted in a cost savings of $14 million, almost double the $7.3 million saved in calendar year 2004.

The Department also requires each contractor to have a fraudulent claims investigation or anti-fraud unit to identify and investigate any pattern of suspicious or potential fraudulent billings. In FY 2005, fraud judgments were ordered for $5.9 million. In addition, the anti-fraud efforts resulted in identifying $3.7 million in benefit dollars for administrative recoupment.

Military Pay. The projected FY 2006 improper payments rate for military pay of $65.9 million (.091 percent) is a substantial decrease from the FY 2005 rate of $432 million (.6254 percent). The FY 2006 decrease in estimated improper payments for military pay is primarily attributed to fewer randomly sampled accounts having confirmed high dollar value erroneous payments. The Department places substantial emphasis on the accuracy of military pay. Several sources identify improper payments for military pay. The Department performs monthly random reviews by Military Service, identifies pay system discrepancies, and conducts special audits or reviews. The Department has established several processes to ensure correctness of pay and thus prevent improper payments within the military pay systems. These include both random and targeted pre-payroll (payday) reviews, and producing pay abnormality and inconsistent condition reports.

In the pre-payroll review process, the Department selects random individual pay accounts from the Military Services for review prior to mid-month and end-of-month payroll release. The goal is to identify any incorrect pay generated by a systems or procedural issue and correct it.

Pay abnormality reports are generated by the pay systems to identify accounts that are receiving pay at a rate of 225 percent or greater increase from their normal pay. It provides the normal pay amount, what is being paid on the current payday, and identifies the input creating the increase in pay. Each account on this list is reviewed in detail to ensure the pay is accurate based on some unique occurrence (e.g., payment of a new entitlement, payment of a one-time item, such as a bonus, etc.)

Inconsistent condition reports identify pay conditions within the pay system that should not exist (e.g., the member is receiving Basic Allowance for Housing at the “no dependents” rate but also is receiving cost of living allowance at the “with dependents” rate). The reports are sent to the appropriate input source for research and correction of the account.

Both system and operations managers are notified of any randomly reviewed pay accounts with over or under payments, as they are detected, from the post-payment review. Also, a monthly report is produced that illustrates monthly and year to date error trends and reasons for discrepancies that impact net pay.

To further reduce improper payments, the Department implemented a process in May 2006 to capture reconciliation rates for overpayments and underpayments identified among the sampled accounts. An interim reconciliation rate target of 93 percent was established for the 4th Quarter of FY 2006. A more definitive rate will be established

for FY 2007 pending the confirmation and analysis of more comprehensive data on reconciliation of overpayments and underpayments among the sampled accounts to ensure accuracy of the Service member's pay.

The Department has also established a Military Pay Improvement Action Plan with five key milestones: Personnel and Pay Leadership and Process Improvement, Personnel and Pay Systems Integration, Interim Improvements to Antiquated Pay System, Active and Reserve Pay Accounts Integration, and Improving Responses to Legislative Changes. The Department appointed a project manager and the plan's implementation is monitored by management, such as the Military Services' Financial Managers, the Business Transformation Agency, and the Defense Finance and Accounting Service Military Pay Operations Directors.

Civilian Pay. The Department also places substantial emphasis on the correctness of civilian pay. The Department has established several processes to ensure accuracy of pay and thus prevent improper payments within the civilian pay system. These measures include targeted pre-payroll (payday) reviews that focus on high visibility areas and those where recent system changes have occurred that impact net pay. In addition, as is the case in military pay, both system and operations managers are notified of any randomly reviewed pay accounts with over or under payments, as they are detected, from the post-payment review. Also, a monthly report is produced that illustrates monthly and year-to-date error trends and reasons for discrepancies that impact net pay. Improper payments for civilian pay in FY 2006 are projected at $62.8 million or .1231 percent.

To further reduce improper payments, the Department implemented a process in May 2006 to capture reconciliation rates for overpayments and underpayments identified among the sampled civilian pay accounts, similar to that for military pay. The Department intends to establish targets for FY 2007, pending confirmation and analysis of more comprehensive data on reconciliation of overpayments and underpayments among the sampled accounts to ensure accuracy of civilian pay.

Commercial Pay. The Department uses various manual and automated prepayment initiatives to prevent commercial pay improper payments. Based on review of improper payment data, detection logic is continually reevaluated and adjusted to improve the detection and prevention of improper payments. In addition, manual review procedures are used for selected high dollar value payments. During FY 2006, the Department identified more than $550 million in improper payments out of the approximately $300 billion in commercial payments, which equates to an improper payment rate of .1830 percent.

In FY 2007, the Department will implement a Business Activity Monitoring service, employing the latest technology to increase the efficiency and effectiveness of improper payment detection efforts.

The Defense Finance and Accounting Service Internal Review Office also conducts periodic independent reviews of commercial payments to improve the Department's improper payment detection, correction, and prevention efforts. Since FY 2003, this office has identified $212.4 million in improper payments of which $197.4 million has been recouped by the Department.

The U.S. Army Corps of Engineers manages the Military Lease Program for all military services. When leased property is sold or leases are terminated without timely notifications to the appropriate contracting officer or real estate office, extra payments may be made after the sale or termination. When such errors are identified, the U.S. Army Corps of Engineers helps correct the error and reminds the Military Service of the importance of accurate and timely notifications.

The U.S. Army Corps of Engineers also manages the utility payments for the Department. When there is a

merger or acquisition of utility companies, payments may be made before the U.S. Army Corps of Engineers is aware of changes to the payee information. To reduce the likelihood of these errors, the U.S. Army Corps of Engineers is monitoring for news of pending/new acquisitions and mergers of utility companies. Additionally, many major companies now notify the U.S. Army Corps of Engineers directly as well as the end user/customer. The U.S. Army Corps of Engineers has also developed queries of all relevant databases to help ensure records are modified promptly upon receipt of change notifications.

In all cases of improper payments, the U.S. Army Corps of Engineers reminds the parties involved of the importance of accurate payments to prevent improper payments and the associated liability. For clerical errors in data entry, the personnel are notified and provided with additional guidance to help prevent the error from recurring.

Improper Payment Reduction Outlook

The following table summarizes the Department's improper payment (IP) reduction outlook and total program outlays (payments) from FY 2005 through FY 2009.

Program	FY 2005			FY 2006			FY 2007			FY 2008 Estimated			FY 2009 Estimated		
	Outlays ($ B)	IP (%)	IP ($ M)	Outlays ($ B)	IP (%)	IP ($ M)	Outlays ($ B)	IP (%)	IP ($ M)	Outlays ($ B)	IP (%)	IP ($ M)	Outlays ($ B)	IP (%)	IP ($ M)
Military Retirement (Note 1)	$35.7	.1381	$49.3	$35.6	.137	$48.8	$37.8	.1283	$48.5	$39.6	.1234	$48.8	$41.3	.1209	$50.0
Military Health Benefits (Notes 2-5)	$7.5	1.17	$87.8	$7.0	2.0	$140.0	$9.0	2.0	$180.0	$8.3	2.0	$166.0	$8.9	2.0	$178.0
Military Pay (Notes 1, 6-7)	$69.1	.6254	$432.0	$72.2	.091	$65.9	$60.3	.5019	$302.7	$63.0	.4676	$294.6	$64.4	.458	$295.1

B - Billions, M - Millions

Note 1: Military retirement and military pay outlays are net amounts (e.g., net of Federal and state withholdings). To estimate net outlays for future years, the percentage of net to gross for FY 2006 is determined and multiplied by the gross outlays reported in the FY 2007 President's Budget submission.

Note 2: The final payment error rate for FY 2005 is 1.17 percent, which is less than the amount reported in the FY 2005 report and the contract performance standard of 2 percent.

Note 3: The FY 2005 outlays include all benefit dollars subjected to the audit process. The total was computed as $7.5 billion as reflected in this chart. Fee for service claims are determined to be susceptible to improper payments as payment is made based upon an individual claim being submitted by a provider or beneficiary based on a certification that the services were provided as billed. The $7.5 billion does not include contracts, such as the dental and the U.S. Family Health Plan contracts, whereby the contractor is 100 percent responsible for improper payments—there is no shared risk with the government. Administrative or change order costs are also not included as those costs do not fall into the definition of areas susceptible to improper payments.

Note 4: Pharmacy claims for FY 2005 and FY 2006 were not included in the audit process. The Department is developing a process for future use.

Note 5: The improper payment amount for FY 2005 is understated by a $3.6 million contract overpayment that was not included in the audit contractor review. The overpayment is being evaluated for recoupment.

Note 6: The FY 2006 decrease in estimated improper payments for military pay is primarily attributed to fewer randomly sampled accounts having confirmed high dollar value erroneous payments. The Department is performing a comprehensive analysis, comparing the types and dollar values of errors from FY 2005 to FY 2006.

Note 7: The military pay outlays appear lower for FY 2007 through FY 2009 because emergency supplemental funding is not included.

Improper Payment Auditing

The Department utilizes a number of different mechanisms to prevent, identify, and collect improper payments to include recovery and contract auditing.

Recovery Auditing. The Department maintains an extensive post-payment process for identifying improper payments. This process utilizes post-payment review techniques, performed both internally and by recovery auditing contractors paid from the proceeds actually recovered.

For agency-wide commercial payments, the overpayment amounts identified for recovery are primarily attributable to internal recovery audit efforts and recoveries identified by other means (including contract reconciliation and statistical sampling as well as contractor voluntary refunds). In addition to the overpayments, these efforts identified underpayments. Approximately $307.6 million was disbursed to correct underpayments in prior years, and $256.2 million was disbursed in the current year for identified underpayments. Around $19.0 million remains in the recovery process or referred to a Department of Defense debt management office for collection.

For commercial payments contractor recovery auditing, the Department has recouped more than $18 million in improper commercial payments since its inception in 1996. During FY 2006, the Navy conducted a pilot to determine the feasibility and scope of a Department-wide recovery audit for the Navy. Based on the results, the Navy plans to perform a recovery audit in FY 2007. The Department anticipates additional recovery auditing by contractors in FY 2007.

The Department utilizes contractors to perform the entitlement process related to health care claims. To ensure the integrity of the payments made, a different contractor performs post-payment reviews using statistical methods to quantify the amount of improper payments. The improper payments estimate becomes an unallowable cost to the vendor making the payment. The Department also is utilizing a recovery audit contractor to recapture overpayments made to hospitals that failed to submit amended cost reports from calendar years 1992 through 1997. From October 2003 through July 2006, these reviews have realized over $20.6 million in recoupments.

	Recovery Audit Activity		
	Agency-wide Commercial Payments	Commercial Payments Recovery Auditing Contractor	Military Health Benefits Recovery Auditing Contractor
Amount Subject to Review for Current Year Reporting	$299.4 billion	N/A	N/A
Actual Amount Reviewed and Reported	$299.4 billion	N/A	N/A
Overpayment Amounts Identified for Recovery	$170.0 million	N/A	$25.3 million
Amounts Identified/ Actual Amount Reviewed	.0006%	N/A	N/A
Amounts recovered Current Year	$133.3 million	N/A	$4.6 million
Amounts recovered Prior Years(s)	$138.3 million	$18.6 million	$16.0 million

Note: Because of timing differences, there is no direct relationship between recovery auditing efforts and actual recovery amounts (e.g., recovery audit effort may have been performed in a previous fiscal year on disbursements made in multiple fiscal years). As a result, the table is limited to the actual amounts recovered in FY 2006 and prior years.

Contract Auditing. The Defense Contract Audit Agency routinely performs billing system audits at major contractors (e.g., contractors with a substantial amount of flexibly priced contracts and fixed price contracts) to determine the adequacy of the contractor's billing system internal controls and its compliance with those controls. This effort provides assurance to the Department that the contract payment billings are based on costs incurred and approved

provisional billing rates. The Defense Contract Audit Agency also performs paid voucher reviews at major contractors and special purpose audits at contractor locations when a risk factor for improper payments is identified and neither a billing system review nor a test of paid vouchers is planned.

Accountability

Certifying officer legislation currently in effect holds certifying and disbursing officers accountable for government funds. Pecuniary liability attaches automatically when there is a fiscal irregularity, i.e., (a) a physical loss of cash, vouchers, negotiable instruments, or supporting documents, or (b) an improper payment. Pecuniary liability for accountable officials attaches if a commander/director determines an improper payment was the result of the accountable official's negligence. For certifying officers and disbursing officers, there is a presumption of negligence and those individuals bear the burden of proof in establishing the absence of negligence, i.e., they must produce evidence to establish that there was no contributing fault or negligence on their part. A presumption of negligence does not apply to accountable officials. Efforts to recover from the recipient must be undertaken in accordance with the debt collection procedures in Volume 5, Chapters 29 and 30, of the Department's Financial Management Regulation.

In addition, the Department actively monitors performance metrics to further reduce improper payments. These metrics include all programs/activities the Department has identified as having a risk of improper payments (i.e., military retired, military health benefits, and military, civilian, travel, and commercial pay areas).

Information Systems

The Department has the information and infrastructure needed to reduce improper payments for five of the six major program/activity areas. For commercial payments, as previously mentioned, the Department is currently in the process of procuring business activity monitoring services, which will employ the latest technology to increase the efficiency and effectiveness of improper payment detection efforts. The Department will prioritize the use of this capability first toward commercial payments and then to all payment areas.

Statutory or Regulatory Barriers

There are currently no statutory or regulatory barriers limiting the Department's corrective actions for five of the six major program/activity areas.

For military retirement, two barriers impede the agency's ability to take corrective actions in reducing improper payments: the Federal Acquisition Regulation and the Retired and Annuitant Pay service contract. In January 2002, the Defense Finance and Accounting Service awarded the Retired and Annuitant Pay service operations to a government contractor. Although most functions remain unchanged from when the government performed these functions, there are now contractual limits to the government's involvement in the day-to-day operations of Retired and Annuitant Pay. The Continuing Government Activity Office was formed to oversee the Retired and Annuitant Pay contract. To ensure the contractual requirements are followed, however, the government can no longer direct how the work is accomplished. To bring about an operational change, both the government and the contractor must agree on how to effect and fund the change. The Federal Acquisition Regulation requires any deviation from the current contract be accomplished via a contract modification.

Additional Comments

The Office of Management and Budget requested that the Department identify Iraq improper payment indicators. In support of this request, additional reviews are conducted on payments for Iraq by the

Defense Finance and Accounting Service and the U. S. Army Corps of Engineers, as discussed below.

The Defense Finance and Accounting Service initiated a survey to identify military contracts and payments made from the Mechanization of Contract Administration Services entitlement system in support of Iraq reconstruction to determine if there were any improper payments made during the first three quarters of FY 2006. The intent of the first phase of the survey is to assess if payments made for Iraq Reconstruction contracts are at any greater risk of improper payments than other contract payments processed under the same system. A secondary review will encompass high visibility/high dollar value Iraq contract payments. The Defense Finance and Accounting Service is also pursuing lists of contracts for Coalition Support (military operations) requirements to enable the post-payment review of contracts paid from the Mechanization of Contract Administration Services. Future plans will be dependent upon the results of these initial reviews and system comparisons. Data is not currently available, as this comparative process is still underway. The Defense Finance and Accounting Service will report results of reviews after the end of the first quarter of FY 2007.

For the U. S. Army Corps of Engineers, a random sample of every 15th item from the population of monthly Iraqi payments greater than or equal to $500,000 is selected for audit. The audit process includes: verifying Prompt Payment Act compliance; reviewing receiving report information to ensure payments were for goods/services actually received; reviewing vendor invoices and supporting documentation to ensure that correct vendors were paid the correct amounts; verifying vendors are not on the contractor indebtedness list; and reviewing appropriation expense coding for validity.

Although the Department has made significant progress toward preventing overall improper payments, identifying occurrences, and acting to alleviate similar future errors, the Department realizes the importance of continuing this critical initiative. In an effort to identify and prevent improper payments before they occur, the Department recently procured a managed service that includes the latest "best in class" private industry Business Activity Monitoring processes coupled with a comprehensive Enterprise Risk Management Strategy Program. The combination of these two processes will allow the Department to (1) more accurately, efficiently, and effectively identify potential improper payments before they occur, and (2) integrate improper payment root cause analysis with existing internal management control program and audit "weaknesses" to assign inherent risks to better isolate areas for future improper payment prevention. Additional FY 2007 Department initiatives to facilitate identification and reporting of improper payments include: (1) periodic workgroup meetings of Military Service and Defense Agency representatives to establish guidelines and ensure consistent reporting and adherence to the Office of Management and Budget implementation guidelines for the Improper Payments Information Act and (2) increased emphasis on data mining or reviewing additional subsets of the pay system populations that are deemed as potentially at higher risk for improper payments.

Funds Managed by the Department for the Executive Office of the President

The Department manages the following funds for the Executive Office of the President:

- International Military Education and Training
- Foreign Military Financing Program Grants
- Military Debt Reduction Financing
- Special Defense Acquisition Fund
- Foreign Military Loan Liquidating Account
- Foreign Military Financing, Direct Loan Financing
- Foreign Military Sales Trust Fund

The consolidated FY 2006 financial statements below summarize the activities of these funds.

Unaudited

Funds Appropriated to the President
Administered by the Department of Defense
Security Assistance

BALANCE SHEET As of September 30, 2006 ($ in Millions)		FY 2006
ASSETS		
Fund Balance With Treasury	$	2,604.6
Non-Entity Other		1,199.2
Accounts Receivable		14.4
Loans Receivable		3,663.4
Total Assets	$	7,481.6
LIABILITIES		
Debt	$	3,315.6
Other Liabilities		377.7
Accounts Payable		67.5
Military Retirement and Other Federal Employment Benefits		0.3
Other Liabilities		1,834.4
Total Liabilities	$	5,595.5
NET POSITION		
Unexpended Appropriations - Other Funds		1,823.1
Cumulative Results of Operations - Other Funds		63.0
Total Net Position	$	1,886.1
Total Liabilities and Net Position	$	7,481.6

STATEMENT OF NET COST For the Year Ended September 30, 2006 ($ in Millions)		FY 2006
Program Costs:		
Gross Cost	$	5,321.0
Less: Earned Revenue		(659.4)
Net Program Costs	$	4,661.6
Cost not Assigned to Programs		-
Less: Earned Revenues not Attributable to Programs		-
Net Cost of Operations	$	4,661.6

Unaudited

Funds Appropriated to the President
Administered by the Department of Defense
Security Assistance

STATEMENT OF BUDGETARY RESOURCES For the Year Ended September 30, 2006 ($ in Millions)	Budgetary Financing Accounts	Non-Budgetary Credit Reform Financing Accounts
Budgetary Resources		
Unobligated balance, brought forward, October 1	$ 81.0	$ 48.0
Recoveries of Prior Year unpaid obligations	10.4	-
Budget Authority		
Appropriations Received	$ 4,601.7	$ 16.0
Borrowing Authority	-	25.6
Contract Authority	373.0	-
Spending Authority from Offsetting Collections		
Earned	-	-
Collected	661.8	1,110.9
Change in Receivable from Federal Sources	-	-
Subtotal	$ 5,636.5	$ 1,152.5
Nonexpenditure transfers, net, anticipated and actual	26.0	-
Permanently Not Available	(254.3)	(1,083.0)
Total Budgetary Resources	$ 5,499.6	$ 117.5
Status of Budgetary Resources		
Obligations Incurred		
Direct	$ 4,588.0	$ 102.2
Reimbursable	199.8	-
Subtotal	$ 4,787.8	$ 102.2
Unobligated Balance		
Apportioned	1.3	0.7
Exempt from Apportionment	696.7	-
Subtotal	698.0	0.7
Unobligated Balances Not Available	13.8	14.6
Total Status of Budgetary Resources	$ 5,499.6	$ 117.5
Change in Obligated Balance:		
Obligated Balance, Net		
Unpaid obligations, brought forward, October 1	$ 2,469.2	$ 3,417.5
Less: Uncollected customer payments from Federal sourcese, brought forward, October 1	-	-
Total unpaid obligated balance	2,469.2	3,417.5
Obligations incurred, net	4,787.8	102.2
Less: Gross outlays	(5,196.1)	(480.4)
Less: Recoveries of prior year unpaid obligations, actual	(10.4)	-
Obligated balance, net, end of period		
Unpaid obligations	2,050.5	3,039.3
Less: Uncollected customer payments from Federal Sources	-	-
Total, unpaid obligated balance, net, end of period	2,050.5	3,039.3
Net Outlays		
Gross outlays	5,196.1	480.4
Less: Offsetting collections	(661.8)	(1,110.9)
Less: Distributed Offsetting Receipts	-	-
Net Outlays	$ 4,534.3	$ (630.5)

Unaudited

Funds Appropriated to the President
Administered by the Department of Defense
Security Assistance

STATEMENT OF CHANGES IN NET POSITION As of September 30, 2006 ($ in Millions)		FY 2006
CUMULATIVE RESULTS OF OPERATIONS		
Beginning Balance	$	69.9
Prior Period Adjustments:		
Changes in accounting principles		-
Corrections of errors		(1.2)
Beginning Balance, as adjusted	$	68.7
Budgetary Financing Sources		
Appropriations Transferred in/out	$	-
Other Adjustments (rescissions, etc.)		-
Appropriations Used		4,722.8
Other Financing Sources:		
Donations and forfeitures of property	$	-
Transfers in/out Without Reimbursement		(66.9)
Imputed financing from costs absorbed by others		-
Other (+/-)		-
Total Financing Sources	$	4,655.9
Net Cost of Operations	$	4,661.6
Net Change	$	(5.7)
CUMULATIVE RESULTS OF OPERATIONS	$	63.0
UNEXPENDED APPROPRIATIONS		
Beginning Balance	$	1,966.6
Prior Period Adjustments:		
Corrections of errors		(0.5)
Beginning Balance, as adjusted	$	1,966.1
Budgetary Financing Sources		
Appropriation Received	$	4,601.7
Appropriations Transferred in/out		25.9
Other Adjustments (rescissions, etc.)		(47.8)
Appropriations Used		(4,722.8)
Total Budgetary Financing Sources	$	(143.0)
TOTAL UNEXPENDED APPROPRIATIONS	$	1,823.1
Net Position	$	1,886.1

STATEMENT OF FINANCING For the Year Ended September 30, 2006 ($ in Millions)		FY 2006
Resources Used to Finance Activities:		
Budgetary Resources Obligated		
Obligations Incurred	$	4,890.1
Less: Spending Authority from Offsetting Collections and Recoveries		(1,783.1)
Obligations Net of Offsetting Collections and Recoveries	$	3,107.0
Less: Offsetting Receipts		-
Net Obligations	$	3,107.0
Other Resources		
Donations and Forfeitures of Property	$	-
Transfers In/Out Without Reimbursement		(67.0)
Net Other Resources Used to Finance Activities		(67.0)
Total Resources Used to Finance Activities	$	3,040.0
Resources Used to Finance Items not part of the Net Cost of Operations:		
Change in Budgetary Resources Obligated for Goods, Services, and Benefits ordered but not yet provided		
Undelivered Orders	$	523.4
Resources that fund expenses recognized in Prior Periods		(26.6)
Budgetary Offsetting Collections and Receipts that do not affect Net Cost of Operations		1,572.5
Resources that Finance the Acquisition of Assets		(480.4)
Other Resources or Adjustments to net Obligated that do not affect Net Cost of Operations		
Other		66.9
Total Resources Used to Finance Items not part of the Net Cost of Operations	$	1,655.8
Total Resources Used to Finance the Net Cost of Operations	$	4,695.8
Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period		
Components Requiring or Generating Resources in Future Periods		
Upward/Downward Reestimates of Credit Subsidy Expense	$	(33.8)
Total Components of Net Cost of Operations that will require or generate Resources in Future Periods	$	(33.8)
Components Not Requiring or Generating Resources		
Revaluation of Assets or Liabilities	$	(0.4)
Other		-
Total Components of Net Cost of Operations that will not Require or Generate Resources	$	(0.4)
Total Components of Net Cost of Operations that will not Require or Generate Resources in the Current Period	$	(34.2)
Net Cost of Operations	$	4,661.6

Appendixes

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Appendix A: *Glossary of Terms*

Acronym	Full Name
BRAC	Base Realignment and Closure
e-Gov	Electronic Government
FEDS-HEAL	Deployment-based medical service contract
FIAR	Financial Improvement and Audit Readiness
FMFIA	Federal Managers' Financial Integrity Act
FY	Fiscal Year
GAO	U.S. Government Accountability Office
IG	Inspector General
IP	Improper payment
IPv6	Internet Protocol Version 6
IT	Information Technology
MRR	Medical Readiness Review
NSPS	National Security Personnel System
OIG	Office of Inspector General
OMB	Office of Management and Budget
PART	Program Assessment Rating Tool
PERSTEMPO	Personnel Tempo
VA	Department of Veterans Affairs

Appendix B: Internal Internet Links
General Information about the Department of Defense

LINKS	TOPIC/SUBJECT
Internal Links	
www.defenselink.mil	Main Department of Defense website, provides daily news about activities, extensive search capabilities, photographs, and links to all Departmental websites
www.dodig.osd.mil	Office of Inspector General's website, which contains information about the OIG's activities and reports
www.dod.mil/comptroller/par	The Department Comptroller's website, which includes the Performance and Accountability Reports since 2002
www.defenselink.mil/qdr/report/Report20060203.pdf	Quadrennial Defense Review (2006)
www.defenselink.mil/execsec/adr2005.pdf	Annual Defense Report (2005)
www.defenselink.mil/news/Mar2005/d20050318nds1.pdf	National Defense Strategy
www.defenselink.mil/news/Mar2005/d20050318nms.pdf	National Military Strategy
www.whitehouse.gov/nsc/nss.html	National Security Strategy
www.dod.mil/comptroller/defbudget/fy2006/index.html	The Department's FY 2006 Budget
www.dod.mil/comptroller/par	Detailed FY 2006 Performance Information (summaries are provided in Section 2 of this report)
www.dod.mil/comptroller/FIAR/index.html	Financial Improvement and Audit Readiness Plan
www.dod.mil/dbt/ETP.html	Enterprise Transition Plan
www.dod.mil/dbt	The Department's Business Transformation Agency website. This agency is responsible for tranforming business operations to achieve improved warfighter support while enabling financial accountability across the Department
www.cpms.osd.mil/nsps	Information on the National Security Personnel System
www.brac.gov	Information about the Base Realignment and Closure process for 2005
External Links	
www.results.gov	Information about the President's Management Agenda
www.expectmore.gov	Information about the Program Assessment Rating Tool (PART) process
www.whitehouse.gov/omb	Office of Management and Budget's website
www.gao.gov	U.S. Government Accountability Office's website
www.cfoc.gov	Chief Financial Officers Council
www.firstgov.gov	U.S. Government's Official Web Portal

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